

The Canadian Chartered Accountant

OFFICIAL ORGAN OF

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

Published monthly; subscription \$3.00 per annum in advance; single copies thirty-five cents. Advertising rates sent on request.

The Editorial Committee will be pleased to receive contributions on subjects of interest. Papers which may not be deemed suitable will be returned, if desired.

Publication Office,
10 Adelaide Street East, Toronto
W. A. McKAGUE, Editor.

VOLUME XLIII

OCTOBER 1943

Issue No. 243

(The opinions expressed in articles in The Canadian Chartered Accountant are the opinions of the writers of the articles and are not necessarily endorsed by the Association.)

Editorial Comment

Conservatism

The accountant in the past has tended to combine the application of accounting principles with the operation of the tenets of business finance. This, at least in part accounts for principles which are labelled accounting but which in fact are a combination of accounting and business finance. A good illustration is the assumed accounting principle in the field of conservatism—"anticipate no profits and provide for all losses".

At the present time when the uncertainties of business are accentuated by war conditions, good business finance calls for the creation of adequate reserves to cover possible contingencies. The tendency in the application of the hybrid accounting principles is thus to weight such principles in favour of the claims made by the business finance aspects of such principles.

As the government of our country becomes a more interested party in the commercial and industrial aspect of our economy through the media of increased taxes, price control and as a major purchaser, there arises a tendency to call for a closer liaison between the various government

departments and business management. From this situation arises the question as to what stand the independent accountant should take towards conservatism when such policies are not consistent with governmental administration in these respective fields.

The scarcity of trained accountants coupled with the increased demand for personnel created by the operation of governmental regulations has led to the suggestion that governmental agencies should place added reliance on the work which is done by the independent accountant. As long as variances of interests exist as between management and the governmental agencies, particularly on the question of conservatism, there does not appear to be a probability that the added reliance is forthcoming, unless the auditor in exercising his independence clearly designates the relative effect of the operation of the business finance aspect of the principle separately from the accounting aspect.

*Tax Reserves
—A Method
of Financing*

An examination of a balance sheet of a representative Canadian firm will indicate that the government through the medium of unpaid taxes is providing, to a certain degree at least, temporary liquid assets.

Until the tax liability is settled the company will have the use of the funds represented for current purposes. The application of the funds may take the form of the purchase of government securities in which case at the date of settlement the securities may be liquidated and the liability settled. Under such conditions no financing problem arises. On the other hand where the retained funds arising from the unsettled tax liability are used by management to meet the increased requirements for inventories and receivables, a problem may arise at the date of required liquidation of the tax liability.

The above situation is of significance to business management under conditions where tax liabilities have increased and provision has not been made for payment by earmarked funds or investments. The time lag between the date of creation and the date of settlement, coupled with a possible decline in the rate of creation due to depressed conditions, brings about the circumstances where the financing problem becomes significant.

Dominion tax authorities, realizing the nature of the

financing operations which are being carried on, coupled with the possibility of failure to obtain funds in such substantial amounts from companies once they have been utilized even temporarily for purposes other than payment of the tax liability, have instituted through legislation provision for a reduction of the time lag. By so doing they have succeeded at least partially in meeting the problem which would no doubt arise when industrial conditions change for the worse.

Although the financing problem has been partially removed by the action of the government, the six-month time lag which still exists as allowed by legislation should be given due consideration by business management in drafting their future financial budgets.

Depreciation Under our present tax rates coupled with the rather firm stand which has been taken by the income tax department in administering the income tax and excess profit tax laws covering the creation of reserves and the provision for contingencies, business management finds itself faced with circumstances where additional funds do not become available from internal sources even though the sales and production of the company have increased considerably. A certain degree of relief may be obtained externally through the medium of trade credit, short and long term borrowing, and expanding tax reserves, but these sources are also limited to a degree. Faced with this situation it is not surprising to find business management claiming either accelerated or special depreciation charges as allowable in the determination of their taxable income.

Although no actual funds are provided by the process of accruing depreciation, under circumstances where a ceiling is placed on the profits earned by a company which might be retained (70% of the standard profit) the accruing of additional amounts of depreciation results in an increased retention of funds which would otherwise be paid out in the form of taxes to the taxing authority.

Depreciation Rates At a time when depreciation is taking such a significant role in the internal financing of companies, it is natural that accountants should pause to consider the nature of the rate customarily used in the determination of this charge

to operations. In the majority of cases where an overall rate is applied to a specific group of assets, whether it be separate individual assets or composites of a single unit, the rate represents an average (straight line) governed by the varying life expectancies of the various component parts of the asset or assets being depreciated.

The matter of the determination of the depreciation rate represents a management decision governed by technical consideration. Whether the judgment of the specialist is accurate can only be measured when the asset has completed its life term. It is only then that the accountant is provided with a concrete basis of evaluating the specialized opinion of management and its technical advisors covering the depreciation rate in use.

If the situation does develop that, applying a recognized overall rate of depreciation, say 10% on machinery, an asset becomes fully depreciated and still remains in use, two possibilities exist as to the cause of the situation. The first is naturally that the rate used has been excessive, and the second is that replacements of the composite units within the major class having a life expectancy below the average for the group have been charged to operations whereas they should have been charged to the reserve for depreciation or to asset accounts.

Replacements Too frequently in the past accountants have explained the situation outlined as resulting from excessive rates, although with due consideration at least part of the discrepancy arises from the accounting procedure which has been followed in regard to the accounting for replacements. If agreement exists that an asset when fully depreciated should be written off against the depreciation reserve created covering the asset, and that the overall rate used represents an average for a composite group of related parts or separate assets having varying life expectancies, then from a strictly accounting viewpoint divorced from what might be good business policy the replacement of any of the composite assets should be properly chargeable to the related reserve for depreciation or to asset accounts rather than to operations.

Report of Forty-first Annual Meeting

THE forty-first annual meeting of The Dominion Association of Chartered Accountants was held at the Royal York Hotel, Toronto, 16-18th August 1943. Representatives were present from all constituent institutes. The President of the American Institute, Mr. George S. Olive, attended as a guest speaker. The registration committee report showed a total of 390 members, 7 visitors and 281 ladies, or a total of 678, which compares with a total of 753 present at the annual meeting in Toronto in 1936.

The executive committee met on the morning of the 16th. Council meetings were on the afternoon of the 16th and the morning of the 17th with a final meeting on the afternoon of the 18th. At the general session on the afternoon of the 17th, the president's address was given and other Association business was dealt with. The general sessions on Wednesday were devoted to technical discussions. The committee on education and examinations met on the evening of the 16th. A number of social events were included.

At the opening general session a welcome was extended by Mayor F. J. Conboy of Toronto and by Russel R. Grant, President of the Ontario Institute. The presidential address of Kris A. Mapp, which included a comprehensive review of the activities of the Association during the year and a consideration of problems which face the profession, was received with enthusiasm. The addresses by Dominion government officials on the subject of "Profit Control and Cost Audits of War Contracts" presented a thorough survey of this important phase of the war and were heard by a crowded room with close attention. The speakers were: B. G. McIntyre, Comptroller of the Treasury, Dominion Government; W. F. Williams, Associate Financial Advisor, Department of Munitions and Supply; and, F. E. Wood, Chief Cost Accountant, Treasury Cost Accounting Division. Mr. Olive, addressing the luncheon meeting on the 18th, dealt with many interesting features of the work of the profession in the United States. The discussion of the T.2 Questionnaire on the afternoon of the 18th was capably handled by C. F. Elderkin and J. Grant Glassco and proved of great interest to the members.

The reports of the provincial institutes, together with

a statistical summary prepared by the office of the secretary-treasurer, were distributed at the annual meeting and are being printed in the Association's Year Book.

The various committee reports are also being printed or summarized in the Year Book.

The president's address was printed in the September 1943 issue of *The Canadian Chartered Accountant*. The other addresses and extracts from the discussions are being printed in subsequent issues. The list of officers elected, and the appointed committee chairmen, appeared in the September issue of *The Canadian Chartered Accountant*. The complete list of committee members is being printed in the Year Book.

OUR ASSOCIATION'S NEW PRESIDENT

Henry Gordon Norman of Montreal, who was elected president of The Dominion Association of Chartered Accountants at its 41st annual meeting in Toronto, 16-18th August, was born in London, England in 1890. In 1911 he came to Canada where he qualified as a chartered accountant at Edmonton, Alberta. In 1914 he enlisted as a private in the Canadian machine gun corps and later was promoted to lieutenant. At the conclusion of the great war he went to Philadelphia where he practised as an accountant with Price, Waterhouse & Co. In 1931 he came to the Price, Waterhouse offices in Montreal with which branch he has since been connected. In 1939 Mr. Norman was retained in an advisory capacity by the Minister of National Defence. In 1940 he was appointed financial advisor to the British Commonwealth Air Training Plan. Mr. Norman is a member of the New Brunswick Institute of Chartered Accountants as well as of the Alberta Institute and the Quebec Society. He is a past president of the Society of Chartered Accountants of Quebec and from 1938 to 1941 was a member of the executive committee of the Dominion Association.

Mr. Norman is a member of the Church of England. He is a member of the St. James Club, the Hermitage Country Club and the Rideau Club. Mr. Norman's main outside interest is farming. Married, he is the father of one daughter and two sons.

TIMETABLE OF EXAMINATIONS

TIMETABLE OF EXAMINATIONS

The Board of Examiners-in-Chief gives notice that the regular examinations for 1943 of the Provincial Institutes of Chartered Accountants will be written during the week of 6th to 11th December according to the following timetable. The morning sessions will be from 9 a.m. to 1 p.m., and the afternoon sessions from 2 to 6 o'clock.

Monday, 6th December

Morning session —Final Auditing I
Afternoon session—Intermediate Auditing I

Tuesday, 7th December

Morning session —Final Auditing II
Afternoon session—Intermediate Auditing II

Wednesday, 8th December

Morning session —Final Accounting I
Afternoon session—Intermediate Accounting I

Thursday, 9th December

Morning session —Final Accounting II
Afternoon session—Intermediate Accounting II

Friday, 10th December

Morning session —Final Accounting III

Saturday, 11th December

Morning session —Final Accounting IV.

AMERICAN INSTITUTE'S ANNUAL MEETING

The annual meeting of the American Institute of Accountants will be held at the Waldorf-Astoria Hotel, New York, October 18-21, 1943. Commenting on plans for the meeting, *The Journal of Accountancy* says: "The program is devoid of provision for entertainment. No appeal is being made to those who may seek an excuse for a holiday jaunt. Hard work will be the order of the meeting. War contract termination problems, contract re-negotiation, claims under section 722 of the Internal Revenue Code, presentation of financial statements in wartime, war economy and postwar planning, problems of wartime practice, including those created by Selective Service and wage and job-stabilization orders, and federal tax problems, will be the principal subjects of discussion."

Profit Control and Cost Audits of War Contracts

By B. G. McIntyre

Comptroller of the Treasury, Dominion Government

(Address at the annual meeting of The Dominion Association of Chartered Accountants, Toronto, 16th-18th August 1943.)

NEEDESS to say I appreciate very much the opportunity of being here today but I may say that when your good president casually suggested I attend your meeting and say a few words, I never contemplated shouldering the responsibility of giving you a long dissertation on the subject that appears in the agenda this morning, namely, "Profit Control and Cost Audits of War Contracts". After all, we have with us this morning two gentlemen: Mr. Williams, financial advisor, Department of Munitions and Supply, and Mr. Wood, the chief of our treasury cost accounting division, both well equipped to give you a detailed description of what is being done to control profits on war contracts. Therefore, anything I may say on the subject will be brief and quite general.

Duties of Comptroller's Office

Since the office of comptroller of the treasury, commonly referred to as the treasury, is a comparatively new branch of the government, it seems fitting that I should give you a brief outline of the organization.

It was established in 1932 by amendment to the Consolidated Revenue and Audit Act and involved the transfer of the accounting staffs of the departments, numbering about 1,000, to the direction and control of the comptroller of the treasury.

Prior to 1932 each department had its own accounting office to audit, pay and account for expenditures—all of which was subject to detailed post audit classification and reporting to parliament by the auditor general.

This Act defines the consolidated revenue fund of Canada as the fund or account to which all revenues and other cash receipts are credited and out of which all disbursements are made.

The statutory function of the treasury organization is to control disbursements from the consolidated revenue fund, as the Act provides that all payments must be made

under the direction and control of the comptroller, and that no payment may be made without parliamentary authority. Under this system the departments' accounts are subject to independent examination and audit before payment. This includes verification that the account is certified by duly authorized officers of the department, is in accordance with the order or contract, and that it is not in conflict with any act of Parliament or rules and regulations of the governor-in-council or treasury board. You perhaps have heard the treasury blamed for delays in the payment of accounts. I can assure you that where proper authority has been obtained and the accounts are otherwise in order, there is no delay.

Delays in Payment

One of the most frequent causes for delay in payment is where the contractors, invariably on the authority of some departmental officers, exceed the authorization granted for the project. In the early days of the war, there was considerable delay due to the lack of inspection and receipt vouchers and the inability of departmental officers to certify that the supplies had been received, also where we had no acceptance of tender from the Department of Munitions and Supply. However, I am happy to say that delay on this account seldom occurs now.

Another provision of the amended act deals with departmental commitments and requires that the treasury shall exercise control over them. Thus commitments coming in course of payment during the current fiscal year may not be incurred unless there is a parliamentary appropriation from which they may be paid. Again, all existing commitments at the commencement of a fiscal year must be made a first charge against the appropriation granted by parliament for the year.

Duplication Removed

Mr. Watson Sellar, who was appointed auditor general on April 1, 1940, was the first comptroller. There had been much duplication of work as between the comptroller's office and the auditor general's office, as the latter had continued his detailed post audits, although the accounts have been subject to independent audit by the comptroller's office since 1932. However, rapid progress has been made in the elimination of this duplication since the present

auditor general was appointed, so that today this duplication no longer exists.

In giving effect to the new plan of audit by the auditor general, it has been necessary to make a major change in the annual reporting of expenditures and revenues to parliament. Heretofore the auditor general compiled and reported the details. Commencing with the fiscal year 1942-43, the public accounts, heretofore prepared by the Department of Finance, and the auditor general's report, will be consolidated and presented to parliament by the Minister of Finance as the public accounts of Canada. The report will be certified by the auditor general and include his audit observations.

The War

Under war conditions we have met with and have had to solve many new problems. We were faced with a rapid expansion in our organization to meet the needs of the three armed services and other new war organizations. It included establishment of an office overseas, followed by one in Newfoundland and recently representatives in Africa and India. At an early date after commencement of hostilities, a treasury branch was set up for the Department of Munitions and Supply and in May of 1940 we established the treasury cost accounting division, under the direction of Mr. Frank Wood, to take care of the needs of the department, as well as those of the treasury, where the terms of the contracts require that an audit be made.

These new and heavier demands for services have meant a substantial increase in our staff, so that the organization numbers 6,500 today: 700 in the overseas offices; 50 in Newfoundland; 1,100 to take care of the needs of the army in Canada; 700 for air; 400 for navy; 950 for dependents' allowance and assigned pay; and 580 for munitions and supply.

Needless to say this expansion was achieved only after overcoming many obstacles. The degree of success we have had is due in no small measure to the transfer of staffs from one accounting branch to another and the number of our permanent officers who proved capable of filling key war positions. This is one outstanding advantage, derived from centralization of government accounting services.

PROFIT CONTROL AND COST AUDITS OF WAR CONTRACTS

During the last war these accounting needs were provided by the defence services.

The following facts serve to indicate the increase in volume of transactions and the extent of our financial demands:

Monthly cheque issue 1939	300,000
Monthly cheque issue now	1,200,000
War expenditure budget for the year, including united nations mutual aid	\$4,900,000,000
or almost three times our total war expenditure of \$1,700,000,000 during world war no. 1.	
Total expenditure budget for this year	\$5,500,000,000
or \$18 million for each work day—roughly twelve times our peacetime spending rate.	

Control and Audit

When we talk of control over war expenditures, we may be disposed to limit this to control over the profits of industry. It is true this type of control is most important and necessary, but it falls short of accomplishing the desired result, unless supported by other very necessary controls.

Realizing this, the government established an overall control of the financial side of Canada's war effort almost from the start of hostilities. Under this system, the proposed programme of war expenditures and all additions thereto are submitted to the war committee of the cabinet for consideration and approval. Following this, each of the services must submit detailed estimates of its war requirements to treasury board for approval.

The approved estimates constitute the authority for the defence services to proceed with organization of the needed establishments and to raise requisitions on Munitions and Supply for the procurement of necessary munitions of war and supplies or construction of facilities. It is the duty of the treasury officer concerned to certify each requisition to the effect that the amount involved is included in the approved estimates. Otherwise, the Department of Munitions and Supply will not act on the requisition.

Next comes the very important controls which have been delegated to the Department of Munitions and Supply as the sole procurement agency for the defence services. On receipt of the requisition, that department must take all reasonable precautions to ensure that the contracts are

placed at the lowest possible cost to public funds. This is no easy task in wartime but I am sure Mr. Williams will describe how the department seeks to accomplish the desired result.

Tenders and Contracts

Under ordinary conditions the purchase and other contracts of the government are entered into only after public tenders have been called. With real competitive bids, there is reasonable assurance that the government receives full value at the lowest possible cost. Under war conditions, it is sometimes impossible, and more often impracticable, to obtain competitive bids of any real value. Thus, the Department of Munitions and Supply is faced with one of two alternatives:

- Negotiating with prospective suppliers; and,
- Where sufficient information is available to properly gauge results, placing the contract at what is described as a negotiated firm price; or,
- Where this cannot be done, the department is compelled to place orders on a cost plus basis, subject to audit, and this is where our treasury cost accounting Division enters the picture.

I am sure Mr. Wood will give you an adequate description of how his branch functions. But I will say that when due allowance is made for the shortage of accountants, our difficulties in retaining those we have, and the great volume of such audits, the job this branch has been performing is a worth while and very necessary contribution to Canada's war effort. But I want you to bear in mind that we do not consider the functions of our cost accounting division as a cure-all against waste and extravagance, in other words, inefficient management.

Cost-plus Contracts

It is essential that the Department of Munitions and Supply exercises close supervision over cost plus contracts, both construction and production, to ensure that purchase of materials, as well as employment of labour, etc., is adequately supervised and the job, as a whole, performed in an efficient manner with due regard for public funds.

There has been criticism of the cost plus form of contract; some of this may be justified as this type has undesirable features which may tend to increase costs, particularly the absence of the usual incentive for efficient management, but adequate government supervision should

PROFIT CONTROL AND COST AUDITS OF WAR CONTRACTS

go a long way to protecting against loss on this account. Modifications in the form of the original cost plus percentage contract have been developed and these produce, at least, a partial incentive for economical production.

However, I believe that a negotiated firm price contract may have equally undesirable results from the viewpoint of the taxpayer. For example, when a firm accepts a firm price on a contract that will continue over a considerable period of time, the company must, of necessity, provide an adequate reserve for contingencies, to cover costs which may arise through delay due to shortages of materials or labour. There is also the uncertainty as to the ultimate productive capacity of the plant and this may have an important bearing on labour and overhead costs. When these contingencies do not arise and production is maintained at a high level, the profit allowance may prove to be, not, say, 5% as intended by the negotiating officer, but, perhaps, 10% or even 20%. The profit realized should always be in keeping with the real capital investment and the extent of technical skill and energy provided.

Production in our war plants should have reached the levelling-off stage by now. The production problems of Munitions and Supply are far less onerous than in the past. The current stores requirements of the armed services would appear to be well supplied. Now is the time to check the record to ascertain whether and to what extent any stores items have been bought in excess of requirements and, if so, what current use can be made of them. We should also check on stocks of materials and supplies carried by or on order for war contracts and eliminate any excess based on prospective need. Such a stock-taking now may pay dividends to the hard pressed taxpayer.

VOLUME OF WORK IN D.A. & A.P. DIVISION

Month of June:

Number of cheques issued	575,000
Number of insurance accounts	80,000
Number of War Savings Certificates deductions	52,000
Victory Loan deductions	152,000
Payments—Dependents' Allowance	14,000,000
—Assigned Pay	15,000,000

1914-18 WAR

WAR APPROPRIATION ACTS

<i>Fiscal Years</i>	<i>Expenditures</i>
1914-15	\$ 60,750,476.01
1915-16	166,197,755.47

THE CANADIAN CHARTERED ACCOUNTANT

1916-17	306,488,814.63
1917-18	343,836,801.98
1918-19	446,519,439.48
1919-20	346,612,964.56

PRESENT WAR

WAR APPROPRIATION ACTS

1939-40	\$ 118,291,021.64
1940-41	752,045,326.06
1941-42	1,339,674,152.42
*1942-43	2,724,248,890.27
*Gift to U.K.	1,000,000,000.00

*War Appropriation (U.K. Financing) Act, 1942.

War Contracts and the Control of Profits

By W. F. Williams

Associate Financial Advisor,

Department of Munitions and Supply, Ottawa

(Address at the annual meeting of The Dominion Association of Chartered Accountants, Toronto, 16th-18th August 1943).

BEFORE going on to discuss War Contracts and the Control of Profits, I should like, if I may, to say just a word or two about the responsibilities and functions of the Department of Munitions and Supply. Many of you are already familiar with our operations, but to others the extent and ramifications of the Department may be surprising, and, in any event, it will give you some of the background leading up to the general topic of this paper. I think it is safe to say that every adult in Canada is affected in small or large measure by the operations of this Department.

As chartered accountants, we find its name—often with astronomical figures after it—written on every other page of the sales records of our clients. In some cases, the Department of Munitions and Supply is not only their best customer, but in actual fact, their only customer. In addition, because of the cost audits demanded by the department, much more work is required of the auditor. This has, I believe, brought the auditor much closer to his clients, particularly those who, before the war, used to feel that the auditor was somewhat of a necessary evil. I judge, from my experience in Ottawa, that the client is now leaning more and more on his auditor, not only for accounting and financial advice, but also as a guide and counsellor in deal-

ing with administration and, to some extent at least, production problems.

As patriotic citizens, we are interested in knowing that the productive facilities of the country are being so marshalled and so co-ordinated that the maximum amount of war material is being produced and delivered in the shortest possible space of time to our fighting forces in the various theatres of war.

As citizens, also, we feel the effect of the various controls that have been set up so that our fighting forces may not be hampered or delayed in speeding the day of victory by shortages of essential materials or supplies. I refer particularly to the restrictions on the use of gasoline, rubber, fuel, as well as the restrictions on travel and on construction.

As taxpayers, we are anxious to know that we are receiving full value for our tax dollar; that the department is following a sound procurement policy; and that every effort is being made to purchase economically and to the best advantage.

The Department of Munitions and Supply came into being on April 9th, 1940. It succeeded the War Supply Board, which itself had succeeded the Defence Purchasing Board.

The incorporating Act—"The Department of Munitions and Supply Act"—gives to the minister great and far-reaching powers. Equally important, it places upon him grave responsibilities and duties. Section 5 of the Act reads as follows:

The Minister shall examine into, organize, mobilize and conserve the resources of Canada contributory to, and the sources of supply of, munitions of war and supplies and the agencies and facilities available for the supply of the same and for the construction and carrying out of defence projects and shall explore, estimate and provide for the fulfilment of the needs, present and prospective, of the Government and the community in respect thereto and generally shall take steps to mobilize, conserve, and co-ordinate all economic and industrial facilities in respect of munitions of war and supplies and defence projects and the supply thereof.

I submit, gentlemen, that that is a gigantic undertaking and a tremendous responsibility. We are fortunate, indeed, in having at the head of this Department, the Honourable C. D. Howe, a recognized and successful engineer and businessman whose ability, common sense and seemingly tire-

less energy are the admiration and envy of every one who comes in contact with him.

Functions of the Department

The functions of the Department may be divided into six parts:

1. **PROCUREMENT.** The first of these functions is that of procuring munitions of war and supplies for the Department of National Defence and for allied governments. We buy only on request or requisition—we are not an originating body. The army, the navy and the air force decide what they need and the quantities required. They also raise the necessary funds and pay for the goods as and when delivered to them by the contractors. However, the responsibility of purchasing their requirements, of deciding from whom they shall be purchased and of negotiating the price to be paid therefor, are the exclusive responsibility of our department. As a matter of practical convenience and in order not to delay unduly the purchasing of certain necessary small items that are needed from day to day, the minister has delegated authority to commanding officers of various units in the services to make minor purchases for specific purposes. The limits of these various authorities are, however, small and for all practical purposes it can be said that the department does all the purchasing.

By far the greater portion of our procurement activities, however, have been on behalf of the United Kingdom, the United States and other allied governments. This has involved not only the purchasing of materials and stores but the expansion of entire industries and, in fact, the creation of new ones. Our chemicals and explosives and shell-filling program, for example, was created largely for the government of the United Kingdom. A crown company—Allied War Supplies Corporation—was set up for the specific purpose of administering and directing this program. It supervises some 45 projects spread across Canada. In order to implement the Hyde Park Agreement another crown company—War Supplies Limited—was incorporated. This company acts as the procurement agency in Canada for the United States government.

While most of our procurement activities are centered in Ottawa, we have established local purchasing offices all across Canada and in Newfoundland. In addition, we main-

tain offices in London and in Washington and Dayton in the United States. We buy everything that you can think of, from aircraft to false teeth, machine tools and machine guns, ammunition and naval vessels, even women's hats and brassieres.

The largest procurement branch of the department, the General Purchasing Branch, is divided into numerous divisions and sections, each specializing in the purchase of a particular class of article and each in charge of an experienced purchasing agent.

With the exception of aircraft and naval vessels, the purchasing of which is done by the respective production branches, the negotiations for the purchase of other munitions of war, such as guns, shells, tanks, automotive equipment, etc., etc., are carried on by the Munitions Contracts Branch.

All of these branches are headed by men with long years of purchasing experience and proven ability as negotiators.

2. PRODUCTION. The second function of the department is that of production. It is our responsibility to see that once the goods have been ordered they are produced and delivered according to schedule. There are several production branches in the department, each headed by a responsible director general and staffed with numerous practical production men and engineers, who work in close co-operation with the technical officers of the armed services and with our contractors. They are constantly striving to assist the contractor in finding new and better methods of manufacture, changes in technique, and ways of speeding up production and reducing costs. The Production Board of the department, under the chairmanship of Mr. H. J. Carmichael, C.M.G., Co-ordinator of Production, consists of the directors general of the various production branches, the liaison officer with the Department of Labour, the presidents of Allied War Supplies Corporation, Cutting Tools and Gauges Limited, the director general of the Economics & Statistics Branch, as well as the co-ordinator of Controls and the Financial Advisor. This board meets once a week to discuss common problems dealing with production and to pass on all applications for capital assistance or certificates of necessity. Their advice and recommendations are passed to the minister and the deputy minister.

In all large projects there is an officer of the department—known as the Munitions and Supply Representative—stationed right in the plant. He is charged with protecting the government's interests in that particular factory and seeing that production is carried on according to schedule. He works in close co-operation with the contractor and reports to the director general of the branch which supervises the production project concerned. It is his duty to see that the goods ordered by the contractor are for the particular contract on which the company is working and also to see that adequate control is maintained over production, labour and expense in general. Close co-operation with the resident cost accountant in this regard, is, of course, essential.

The Dominion Arsenal, incidentally, which formerly were under the control of the Department of National Defence, have for some time now been a very important production branch of this department.

3. CONTROLS. Another function of the department is that of ensuring that there will be an adequate supply of the various commodities in Canada for the carrying on of the war effort. In order to carry out this function, there have been appointed several controllers. These controllers—I think there are seventeen of them—are appointed by order-in-council and their powers are fixed by the order appointing them. The controllers, acting jointly, form what is known as the Wartime Industries Control Board, under the chairmanship of Mr. Henry Borden, K.C., C.M.G., Co-ordinator of Controls. This board meets every second week. Membership of the board consists not only of the controllers but also of the Co-ordinator of Production, the Financial Advisor, the Priorities Officer, the Liaison Officer with the Department of Labour, and the Associate Co-ordinator of Controls from within the department and, in addition, from outside the department, the Deputy Minister of Labour, the chairman of the Wartime Prices and Trade Board and the president of the Commodity Prices Stabilization Corporation. You are all probably familiar with the work of the controllers and, no doubt, have felt the impact of their rulings and regulations on your day-to-day life.

4. GOVERNMENT-OWNED COMPANIES. In order properly and efficiently to carry out some of our responsibilities, it became necessary to do certain things which

could not conveniently and expeditiously be performed by a department. It was felt that the corporate form of administration might be more suitable. Mr. Watson Sellar, the Auditor General of Canada, in an address before the Society of Chartered Accountants in the Province of Quebec, at their annual dinner in March last, has told the story of how these companies originated in the mind of a prominent member of our profession, the late Honourable Gordon Scott, whose tragic and untimely death was a severe blow, not only to the accounting profession and the financial interests with which he was associated, but to Canada as a whole. Gordon Scott was one of the organizers of the War Supply Board and later the Department of Munitions and Supply. In company with Mr. R. A. C. Henry, Mr. Henry Borden and Mr. Sellar, he helped to formulate the policies and procedure in those early days when few people realized the magnitude of the task ahead.

There are now twenty-seven government-owned companies—or at least there were twenty-seven when I left Ottawa two days ago. There seems to be a new one incorporated almost every other month. These companies were each formed to meet specific problems, but they can be roughly divided into manufacturing companies, merchandising and purchasing companies, and supervising or administrative companies. The act provides that the Auditor General of Canada shall be the auditor of these companies.

With few exceptions these companies were incorporated under the Dominion Companies' Act. The shares, with the exception of those necessary to qualify the directors, are all held by the Minister of Munitions and Supply. The directors' shares are registered in their name, endorsed in blank and turned over to the minister, together with their resignations. In addition, the minister and the companies enter into agreements which set out the work to be performed, the powers delegated and other relevant matters. These agreements all provide, however, that the Minister shall have complete control over the affairs and operations of the companies at all times.

The presidents and directors of these companies are all outstanding businessmen, who have been picked by the minister for their experience and ability in the particular task he has in mind for them. With one or two exceptions all serve without salary or remuneration.

While the president is the head of each company, and in most cases a very active head indeed, you will be interested to know that there are a great many chartered accountants in responsible executive positions in most of them. The comptrollers and secretary-treasurers of these companies are, in the majority of cases, chartered accountants. The president of one of them—War Supplies Limited—is a chartered accountant. In the numerous projects supervised by Allied War Supplies Corporation there are also many chartered accountants. They are representatives of nearly all the provincial institutes. It is fitting, I think, that these companies which owe their origin to a chartered accountant, should have so many chartered accountants aiding in their administration.

5. FINANCIAL. The financial functions of the department are centered in the office of the financial advisor, Frank H. Brown, who no doubt is well known to many of you. Mr. Brown who has been associated with financial interests all his business life, is a high ranking executive of the Canadian Bank of Commerce. The duties and responsibilities of the financial advisor include not only advising the minister and the deputy minister on financial matters but also general responsibility for the purchasing policy of the department, the control of profit margins, the arrangements in connection with management fee projects and, when necessary, the financing by the department of contractors operating for us. In addition, all capital assistance recommendations, if for more than \$50,000—including those for certificates of necessity—are passed to him for consideration from the financial angle. This also applies to any transactions of more than \$50,000 which represent any departure of importance from the standard policies of the department. All proposals requiring the approval of the loan committee must have the recommendation of the financial advisor.

Our office receives a copy of every cost audit report forwarded to the various directors general by the chief cost accountant of the treasury. When these reports arrive they are examined in detail, and, if they contain anything of an unusual nature, we confer with the director general concerned before he communicates with the contractor. In the event that a refund is indicated, the request for this refund is forwarded to the contractor through our office.

It is also part of our responsibility to see that all refunds are received and forwarded to the particular treasury concerned so that the proper accounts may be credited.

The renegotiation of contracts—which will be discussed in more detail later—is also one of the responsibilities of our office.

Closely allied to the financial functions of the department is the comptroller's branch, presided over by A. Stan Tindale, M.B.E., for some years a member of the council of the Ontario Institute. In my humble opinion, Mr. Tindale has one of the biggest and most responsible accounting jobs in the government service.

This branch—essentially an accounting branch—has a staff of about 450 people and is divided into several divisions. The Overseas Accounting Division is probably the oldest and handles the accounting work in connection with our purchases on behalf of the United Kingdom government. Another division performs the same functions in connection with our purchases for War Supplies Limited. The cloth accounting division maintains detailed accounting and stores records of all cloth purchased by the Department and sold to uniform manufacturers, who are required to buy their cloth from us and who must make payment in cash before the cloth is delivered to them. In this way we control the quality, colour and specifications of all the cloth going into the uniforms for the fighting services.

Other divisions of this branch are the Production and Stores Accounting Division, the Central Inventory Records Division which is responsible for the maintaining of adequate records, showing the whereabouts of all government-owned plant and equipment as well as the tagging and proper identification of such equipment. Other divisions are devoted to the handling of the sales taxes and duties, the recording of all government expenditures by way of capital assistance and the preparation of the budget estimates of expenditures by the department. This latter function is personally supervised by H. H. Haydon, the assistant comptroller, who is somewhat of a genius at guessing months in advance what the departmental expenditures will be. I have frequently been amazed at the sheer wizardry of his prognostications.

Early this year, Canada took over the interest of the United Kingdom government in working capital as well

as fixed plant and equipment in this country. These investments are of such diversity and magnitude that the total amounts involved will not likely be finally established for some time to come. This is just another task for the comptroller's branch, as is the accounting for the mutual aid commitments of the government.

Supervising all these various divisions of his branch, keeps Mr. Tindale fairly busy. In his spare time however, he is expected to advise government-owned companies and management projects on accounting matters; to see that all field forms are received promptly from these projects; to see that the necessary operating funds are provided; and on special occasions arrange for urgent payments to contractors on very short notice.

6. ADMINISTRATION. As you will have guessed by now, the administering of a department so varied and complex as that of the Department of Munitions and Supply with just under 5,000 employees, requires a genius for organization, administration and attention to detail of the highest quality. In addition, it requires the patience of Job and the placid disposition of an archangel. In G. K. Sheils, the deputy minister, we have the master organizer. He is also long suffering, heaven knows. Those of us who know him best sometimes feel that he falls slightly short of having the archangel's temperament. He has, however, performed a remarkable task in guiding and directing the various branches of the department and seeing that everyone keeps "on the rails". This is no minor feat when you consider that the vast majority of the officers of the Department come from commercial life where practices and procedures are, to say the least, somewhat different from those found in government circles. Mr. Sheils came to the War Supply Board as director of administration and on the formation of the department was appointed deputy minister. He is most ably aided and supported by the assistant deputy minister, J. P. Pettigrew, and a capable and tireless staff of competent assistants.

Other branches of the department include the U.S. Purchasing Branch, the Economics & Statistics Branch, the Defence Projects Construction Branch, the Priorities Branch, the Industrial Security Branch, the Scrap Disposal Branch, the Publicity Branch, the Secretary's Branch, and

the Organization and Personnel Branch, and last, but by no means least, the Legal Branch.

When we consider the large number of contracts and contractual relations with which we have to deal, the essentiality of a legal branch is obvious. Mr. K. B. Palmer, O.B.E., an able and prominent Toronto lawyer, is general counsel for the department and is the ruling head of the legal branch. The director general of the legal branch, J. de N. Kennedy, also of Toronto, has under him a number of lawyers who are skilled in contract work and others who have had much experience along specialized lines. There is an abundance of legal talent available for every type of problem.

Broad Scope of Department

That is a very condensed outline of the functions of the Department. There are numerous other phases of our work which I have not touched on but which, nevertheless, are important and necessary.

While our first job is to procure as speedily as possible those munitions of war and supplies that are so direly and urgently needed, we have, at the same time, the responsibility for seeing that the government gets the maximum possible value for the taxpayer's dollar. This involves not only seeing that profits are fair and reasonable, but that costs are driven down in every possible manner.

I should like, therefore, to discuss the contracting policy of the department, the various types of contracts, the controls exercised over them, and, finally, some of the principles that have been adopted by the department in the renegotiation of contracts.

Before going further, however, there are three points which I should like to draw to your attention. The first is that Canada, prior to the war, had never been a manufacturer of military, naval or aircraft stores. We had not made a single gun or tank prior to the war, and I am told that for over 20 years prior to 1939, our production of cargo or merchant shipping vessels was practically at a standstill. While it is true that we had manufactured some commercial aeroplanes before the war, we had never made a single combat 'plane, and I am sure that you will all agree that there is a vast difference between a commercial 'plane and a combat 'plane.

The department was thus faced with having to purchase huge quantities of military stores never before made in this country and of so doing under conditions demanding *action* above all else; yet with the ever present necessity for every possible consideration being given to wisdom in, and control of, expenditures. We would go to a manufacturer and ask him to make certain military stores for us. Since he had never made these stores before, it was not possible for him to submit a cost estimate. Our own information as to costs was about as extensive as his. It is true that in many instances we had the very able assistance of officers of the British Purchasing Commission, but it is also true that usually the costs supplied by them were established in England where manufacturing methods and techniques were quite different to Canadian practice. You will appreciate, I am sure, the extreme difficulty in attempting to negotiate on the subject of prices when often both the negotiating officer and the contractor had only the very foggiest idea as to the costs of the particular store required.

The second point I would like to mention is that there is general agreement among the negotiating officers of the department that the type of contract that surpasses all others in securing efficiency and economy, is the short term fixed price contract, in which the contractor undertakes to furnish to the department "X" number of articles at "Y" dollars each. This is the usual type of contract that everyone was accustomed to in peace time. Obviously, it has many advantages, both for the contractor and for the government. There is a very definite incentive for the contractor to reduce costs, but on the other hand, he assumes all the risks, including possible increase in the price of raw materials, increased labour costs, delays caused by scarcity of certain materials and various other contingencies.

The third point, then, arises and becomes the principal problem, namely, "How are you going to negotiate safely, fixed price contracts on stores that not only have never before been made in this country, but concerning the costs of which neither the department nor the contractor has the slightest idea?" That, briefly, was the fundamental problem confronting us in 1940, in connection with much of our purchasing and procurement of munitions of war.

The Contracting Policy

It was necessary, therefore, for us to set up a policy, a technique if you will, which would enable us, in so far as it was possible to do so, to place the maximum number of contracts on a fixed price basis, and at the same time discharge our responsibility of seeing that we received full value for every dollar spent. We feel that wherever possible, we should use the competitive tender system as the best method of finding the most efficient contractor. While there has been some criticism of the tender system, we adhere to the view that if we can get both real and honest competition between three or more contractors, we are likely to get low prices on the first order and still lower prices on subsequent orders. Practically all of our purchases of food stuffs, barracks stores, supplies, clothing and equipment of that kind have been purchased on the tender system. Much of the success of this system, however, depends on effective competition and on the ability of the negotiating officer to obtain full, complete and accurate knowledge of the up-to-date costs of the contractor from whom he is purchasing. Where this data is not available, as, for example, in the case of tanks and certain guns, we have had to work out variations and modifications of this type of contract such as the target price contract, which will be referred to later. It is at this point that the cost audit comes in.

The information secured over the past three years by Mr. Wood, the chief cost accountant of the treasury, and his staff, is truly amazing and has been of invaluable help to our officers in negotiating with contractors, many of whom, up until the time the treasury auditor visited them, had no idea of what their production was costing, but who are now becoming more and more "cost conscious". Not only has Mr. Wood's staff completed an amazing number of cost reports—their quality has been of the highest. It is seldom that contractors have questioned the accuracy of these reports as finally issued and delivered to us. When, on the rare occasion, a contractor does question the determination of the cost, we always send him back to Mr. Wood to iron the matter out. We do not, as a department, enter into any discussions on the question of costs. Mr. Wood's organization is a fact-finding body and his reports, when presented to us, are accepted as factual. There are times,

however, when a question of interpretation may be involved or the admissibility of certain items which, strictly speaking, might not properly be considered as an element of cost. In such case, we usually sit in with Mr. Wood and the contractor in an endeavour to arrive at a mutually satisfactory settlement.

It is not always possible or desirable to call for tenders. Instances arise where it may be necessary to use the entire facilities of an industry or where the articles required are of such a technical or secret nature that it is most desirable to confine production to one contractor. In these cases contracts are entered into following negotiations between our officers and the contractor and approval by the governor-in-council where required. Incidentally, all contracts calling for an estimated expenditure of over \$15,000 must have this approval before being entered into. The only exception to this is where, in the minister's opinion, it is necessary to enter into a contract immediately to ensure adequate provisions for the armed forces.

Control of Profits

There are two rather prevalent misconceptions in regard to our purchasing policy which I should like to refer to here.

The first of these misconceptions is that the majority of our contracts are let on a basis of "cost plus". This is definitely not so. By far the great majority of contracts, in so far as number is concerned, are placed on a fixed price basis. In so far as the dollar value is concerned, no accurate figures are available, because the form and value of contracts are constantly changing. My observations, however, have convinced me that in this case also the larger proportion would be on a fixed price basis.

The other misconception to which I refer is that those contracts, which are rather loosely described as "cost plus" contracts, are all of the type which provides a contractor all his costs of manufacture plus a stipulated percentage of those costs as profit. This again is definitely not the case. We have, it is true, numerous contracts on a "cost plus fixed fee" basis but this is an entirely different thing from "cost plus percentage". In the latter case there is no incentive whatever for the contractor to reduce costs—quite the contrary. On the other hand, the "cost plus fixed

fee" type of contract does provide an incentive for cost reduction.

Under certain circumstances, to which I will refer later, there would appear to be some justification for the use of a "cost plus percentage" type of contract; but it is the least desirable type from our point of view and we try to avoid it wherever possible. Where contracts have already been entered into on this basis, (mostly in the early stages of the war) we have tried to convert them to a more preferred type. It is our hope that some day in the reasonably near future, there will be few, if any, of this particular type of contract in existence.

Profit control depends of course to a great extent on intelligent purchasing. Conversely, intelligent purchasing is concerned not only with the control of profit, but with the contractor's costs of manufacture as well. It is, for example, a comparatively simple matter to control the margin of profit by the use of a "cost plus percentage" contract and at the same time let the costs take care of themselves. That, however, is not sound purchasing. We must be concerned with cost and cost reduction as well as with profit margins.

It is generally conceded that high efficiency and low costs go hand-in-hand. Production, of course, is of prime importance, but if we can induce the contractor to lower costs, it should follow that we will get increased production.

While most contractors take pardonable pride in reducing costs, not only from a patriotic desire to make a worthwhile contribution to the war effort, but also because of a keen interest in the job itself, it is nevertheless true that the type of contract under which a manufacturer is operating can have a direct bearing on the manner in which the production is carried out. It is desirable, therefore, that the profit motive as an incentive to cost reduction should be present, as far as possible.

Contract Types

There are five general types of contract commonly in use in the department, with certain variations and modifications of each type. They are referred to in the order in which they are most generally favoured by our negotiating officers.

1. **FIXED PRICE.** As I have already stated, the fixed

price contract following genuinely competitive tenders is considered to be the most effective for our purposes. It is a prerequisite, however, that competition must be real and aggressive. The operations of a cartel or any collusion in bidding must be eradicated. If there is any indication that such practice exists, we may split the order with two or three contractors and arrange for cost audits of all.

Fixed price contracts are usually for comparatively short periods—three to six months. Repeat orders for the same type of store are usually negotiated at lower prices. In this way the contractor retains any additional profit he may make by reason of his ability to reduce costs during the contract period, but he is expected to pass these savings along to the department in the following period.

The target price contract referred to previously is frequently used as a starting point for arriving at fixed prices. Where large quantities of new or unusual stores are required and where there are few design changes or where it is not possible to get competition, the target price type of contract is ideal.

A target price is exactly what the name implies—it is something to shoot at. Its operation is as follows:

Let us suppose that we require 100,000 articles never before produced in this country. After much negotiation, we may agree on a cost for the first 5,000 of these articles at say \$20 each. This price is checked by our officers in comparison with the prices elsewhere, if we can get them, and the various items making up the contractor's estimate of cost are thoroughly examined and verified. If the first 5,000 articles are produced at the target cost of \$20, the contractor will receive in addition to this cost, a profit which is usually figured at 5 per cent of this target cost. It is not shown as a percentage, however, but as so many dollars—in this case \$1. The total cost to the government is then \$21 each for the initial quantity of 5,000 units. If, however, the contractor can reduce the cost below the \$20 target price, he receives in addition to the \$1 profit, a bonus of 25 per cent of the savings between the actual cost and the target of \$20. Thus, if he can reduce the cost to say, \$16 per unit, he will receive in addition to his costs the \$1 profit plus a \$1 bonus or \$2 in all and the cost to the government will be \$18 per unit. If, however, his costs exceed the target, his profits are reduced usually by the

same percentage of the excess. He is, however, guaranteed a minimum profit which may be 2 or 3 per cent of the target, regardless of the cost. Once cost audit reports have been received from the chief cost accountant (which reports will show in addition to the actual cost of the target quantity, a projected cost for future production) it is not usually difficult to arrive at a fixed price basis for the remainder quantity. Sometimes it may be desirable to cost a further target quantity before arriving at a fixed price.

Fixed price contracts are also entered into on occasion, following engineering or pre-costing estimates. They are usually limited, however, to contractors whose rates of overhead have been established by previous cost audits and are usually confined to orders where the total value of the contract is not large.

2. **COST PLUS FIXED FEE.** Perhaps the most common type of contract under this heading is that of actual cost plus a fixed profit per unit of production. While it may be argued that this type of contract does not provide a direct incentive to the contractor to reduce his costs, it does however carry an inducement to the contractor to increase the speed of production for the greater the number of units he can turn out, the greater will be his profit. This should mean, of course, more efficient operation and more efficient operation usually results in lower costs.

Another type of contract similar to this, is the cost plus a fixed profit per unit of output plus a bonus for early delivery or cost reduction. This type of contract demands accurate cost information so that a reasonable basis may be set for the bonus payment. Providing this information is available, this type of contract may be used to advantage in the purchase of larger items, such as ships, aircraft and gun mountings.

Another variation of this type of contract provides for cost plus a management fee. This form, however, is used almost exclusively where the plant and equipment is owned by the government, but operated by a private concern. The fee may be set as so many dollars per unit of production or it may be based on the estimated value of the production over the period of a year and paid monthly. There are several variations of this type of contract.

3. **COST PLUS A FAIR AND REASONABLE PROFIT.** This type of contract provides that the contractor shall be

reimbursed his costs and shall receive in addition a profit to be allowed at the minister's discretion, with the understanding that the amount of profit so allowed will depend to a very great extent on the efficiency with which the contractor has carried out his contract.

4. **CEILING PRICE.** Contracts of this nature set a limit or ceiling on the price to be paid to the contractor per unit of production. The contract may provide that following audit of his costs, he will receive those costs plus an agreed rate of profit. If the costs plus the agreed profit work out at less than the ceiling price stated in the contract, the government receives a rebate of the difference. If, however, the costs plus the profit or, in fact, the costs alone, should go beyond the ceiling price stipulated in the contract, the government is not obligated to pay the excess. This type of contract, unless carefully negotiated, is open to somewhat the same objections as the "cost plus percentage" contract. Great care must be used in establishing the ceiling price to be used. It is usually provided that the profit shall be a fair and reasonable one and settled after the job has been completed. In this way if the contractor can show that he has done something out of the ordinary in the way of efficiency or cost reduction, he may reasonably expect to receive consideration when profit margins are discussed.

5. **COST PLUS PERCENTAGE.** This is the type of contract that was fairly common during the last war and to which so much objection has been raised. There is no incentive to reduce costs, for it is obvious to anyone that the greater the cost, the greater the plus. We are quite in accord with this objection and as I have already stated, we try to avoid its use if at all possible.

It is not always possible however, to refrain entirely from purchasing on this basis. It is sometimes necessary to resort to this style of contract, particularly in connection with the purchases of those items which require numerous changes in design or specifications or where there is a great variety of small items, such as spare parts, for various munitions, aeroplanes, etc. It is also necessary to use it in connection with aircraft repair and overhaul where it is impossible to estimate in advance with any degree of accuracy, the extent of the work to be performed.

There are certain other types of contracts used for vari-

ous purposes, but they are in the main variations of these that I have mentioned.

Profit Margins

Profit margins on all our contracts are based on a relationship to cost of production. This cost, however, is not necessarily the contractor's cost, but must be determined in accordance with the provisions of the departmental costing memorandum, known as M. & S. 433, with which most of you are doubtless familiar and which will be referred to by Mr. Wood later.

The contractor has a right to ask a reasonable profit. This, however, must not be confused with his need for working capital. It should not be assumed, moreover, that under war conditions he is entitled to as great a margin of profit as that to which he is accustomed under competitive conditions in normal times.

We have frequently been asked "What is a fair and reasonable profit?" The answer, of course, is the same as the answer to "How long is a piece of string?"—"It all depends".

There are so many factors entering into the question of what is a fair and reasonable profit, that it is difficult to enumerate them all. Some of the things to which we give consideration are the rate of turnover, the quality of the production, the efficiency of the manufacturer in reducing costs, economy in the use of raw materials, the amount of engineering and inventive genius necessary in the production of the particular stores being manufactured, whether or not they bear any relationship to the peacetime product of the contractor, the volume of sales, the proportion of sales for war products to the total sales, the relationship of the profits to the net worth of the business, as well as the complexity of the manufacturing technique involved and the amount of government-owned or company-financed facilities used in the manufacture of the particular product.

We make no attempt to fix actual percentages for use in determining excessive profits. It goes without saying, I believe, that these will vary in accordance with the circumstances. We do feel, however, that other things being equal, contractors in the same line of business must be treated alike.

An impression has unfortunately gained credence in some quarters that the department is slavishly addicted to allowing a profit of 5 per cent on all contracts. This also is definitely not the case. While it is true that 5 per cent is the focal point, there are many cases in which 5 per cent profit is much too high, particularly on large contracts where the productive facilities and finance are provided by the government. It may also be much too high where the items manufactured are of a simple character and the manufacturing cycle is comparatively short in time. On the other hand, 5 per cent may be unduly low, in the case of highly technical stores, on which the manufacturing cycle is long and the output small in relation to contractor-provided facilities with current financing at the contractor's expense. Moreover, special service in matters of design, delivery, assistance to other contractors, engineering and other considerations, warrant due consideration. The rate of profit, for example, on a small order which involves a considerable machine set-up, would naturally be higher than that allowed on a larger order. The rate of profit should be related to the contribution and performance of the contractor and not to a fixed statutory percentage. There must be no thought on the part of anyone, however, that large profit margins can be allowed. A range running from 1 to 10 per cent should meet every normal situation.

Taxation

We have been told from time to time by contractors that we concern ourselves entirely too much with cost—that under the present high rate of taxation the government will get all the profit in any event. This, to my mind, is not sound thinking.

The problem of excessive war costs and profits is primarily a problem of pricing and not of taxation. Heavy taxation does not meet the problem. Furthermore, our responsibility is with fair and reasonable prices, not with the profit which remains with the contractor after the payment of taxes. Our concern is with costs and rates of profit margin on costs not with net profits on contractor's investments.

Nevertheless, the incidence of excessive profits taxation is such that many contractors claim all incentive has been taken out of their business. This ought not to be true

because the taxation on standard profits is far from confiscatory and the post-war refund on their excess profits can easily be substantial. Apart from that, the freedom of the nation and, in fact, the survival of our existing mode of living, should in themselves be sufficient incentive.

In point of fact, however, the urge to show good profits is so great in the majority of manufacturers, that in most cases it is a marked exaggeration to contend that the weight of taxation destroys initiative and incentive for cost reduction. In this latter connection, any contractor who expects to survive during the post-war period knows full well that efficiency and low costs now are of the utmost importance. Whether his financing at that time will be done by means of a bank loan or by public issue, one thing is certain—he will have to show a record of economical operation.

We must have particular regard to those contracts which have been placed on behalf of the United Kingdom or other allied governments. These purchases have been much greater than those made for the account of the Canadian government. We have told these governments that we will not tolerate large profits on purchases made for their account. We have assured them that the Canadian treasury especially will not profit at their expense. For this reason we do not charge them customs or excise duties on articles manufactured for and delivered to them. If we were to adopt a less rigid attitude in our purchasing of munitions of war for the account of these allied governments, and allowed the contractor to make all the profit he desired and then took it away from him by means of excess profits taxation, we would in effect be collecting that profit for the Canadian treasury at the expense of the other governments.

In a recently issued statement in the United States, Under-Secretary for War, Patterson, and Under-Secretary of the Navy, Forrestal, when dealing with the question of profit margins, remarked that without making set rules, profit margins of from one-third to one-half of those normally prevailing on peacetime business will afford adequate remuneration to war contractors on the large volume of business that they do. Such a standard will usually correspond in point of fact with our range of from one to ten per cent with five per cent the focal point. In England,

the same general standards prevail, and in all free countries, the point is clear that these margins are calculated before computation of the tax burdens which all must bear if the war is to be financed without catastrophic inflation.

Renegotiation of Contracts

At the last session of parliament, the Department of Munitions and Supply Act was amended in many respects. One of these amendments had to do with the renegotiation of contracts. The relevant Section is No. 13 and the fourth sub-section of that section. As amended, the sub-section now reads as follows:

If the Minister is satisfied, upon an examination of the accounts and records of a person who has entered into a munitions contract, that the contract price paid and payable to such person contains an unreasonable profit, he may direct such person to renegotiate the contract price and may direct that there be withheld from such person any amount of the contract price which in the opinion of the Minister represents an unreasonable profit, and may direct such person to pay to the Receiver General of Canada forthwith any amount which such person has received which in the opinion of the Minister represents an unreasonable profit.

Under Order-in-Council P.C. 9159, and amendments thereto, the Minister already had the power to demand refunds from sub-contractors who had made profits in excess of what he considered to be fair and reasonable where such sub-contracts stemmed from a prime contract with the Department which had been placed on a basis of cost plus a fee or percentage or, in fact, where it only related to cost as, for example, in a capital assistance contract. This amendment, however, gives the Minister power to renegotiate any contract.

Renegotiation of contracts has, as you know, become a major instrument of purchasing policy in the United States. Whether it will become a major item in Canada later on, I am not in a position to say. Up to the present, however, we feel that by and large our policies have been effective in getting low prices. Thus there should be no necessity for revising our purchasing methods in any important degree. Consequently we have not renegotiated those contracts where the profit margins have been only moderately above our general standards. To do so, might tend to eliminate the incentive to cost reduction efficiency. What we are aiming at are the inordinate profits that occasionally develop in spite of all our precautions.

We recognize very clearly that when so much stress is placed upon production and when there are frequent changes in specifications that excess profits are bound to occur from time to time. The existence of excess profits, however, should not be construed as meaning that the negotiating officer has failed to make a good bargain or that the contractor has "pulled a fast one" on the government. What has happened is that, due to the lack of previous experience in regard to the costs of production, many contractors have been left with profits which they did not anticipate and which they did not wish to retain. There have been any number of contractors who have come to us and voluntarily refunded large sums representing profits they had not contemplated when they entered into contractual relationships with us.

Even before the present income and excess profits tax came into effect, these refunds ran into several millions of dollars. Our experience in this regard confirms our opinion that the vast majority of Canadian manufacturers are patriotic citizens. The number of contractors who deliberately set out to take advantage of the government has been very, very small—far less than we might reasonably expect. When, however, we do discover such an individual we do not hesitate to take prompt and appropriate action.

When it is brought to our attention either through one of the production branches, the crown companies or through other means, that there is reason to feel that an undue profit is being made on any contract or group of contracts, we first secure all the information available in the departmental files and from other convenient sources.

We then communicate with the contractor and ask him to send us copies of his financial statements, duly certified by his auditors, usually for the past five years. We try to confine our initial request for information to data that will be readily available. We are naturally interested in his operating statements and a breakdown of his sales for the periods under review. This breakdown should show the work he has been doing on prime contracts from the department, sub-contracting work, and ordinary commercial sales. We also obtain the background and history of his organization and the extent to which he has been financed either by the government or through the medium of special depreciation.

When this information is received, it is analyzed and compared in detail with similar information for other contractors in the same general line of business. If contracts have been placed through the department, it is also examined in the light of the information contained in the relative departmental files.

If the preliminary enquiries indicate that an undue profit has been made, the contractor is again communicated with and such further investigations as to the general situation are made as we consider necessary. We frequently make use of the company's own auditors in this work, always reserving the right to use the treasury cost accountants. We look into all the contracts in which the department is interested, including sub-contracts and compare the information secured with any cost audit reports that may have been made by the treasury cost accountants.

When we have secured all the information we require, we discuss the matter with the particular branches, controls, or crown companies concerned, sending them a synopsis of our findings and asking them for their views. We then ask the contractor to come to Ottawa and sit in with us for a general discussion. This discussion, incidentally, is informal and the contractor is encouraged to tell us of the part he has played in the war effort and is given full opportunity to put forward any representations he may wish.

After full and free discussion, during which the contractor outlines his position and we set forth the position of the department, it is not usually difficult to arrive at a basis of settlement which will be satisfactory both to the contractor and to the department. We have found that once a contractor has satisfied himself that we have no desire to put him out of business, but that we want to be assured that no one, including his competitor, is making more than a fair and reasonable profit on war orders, we can count on his full co-operation.

Unless our preliminary examination of the statements submitted by the contractor show unreasonable profits in relation to all the circumstances, no further action is taken as I have said, we are not re-opening contracts in which the profit margins are only very slightly above our standards. The ones we are concerned with are those where these margins are so high as to indicate that the calcula-

tions on which the original prices were settled were erroneous or overly-cautious, or that some improvement in production technique has reduced the cost of the work to an extent beyond anything originally contemplated.

In closing, I should like to stress what seems to me to be an important point. The recent amendments to the Department of Munitions and Supply Act provide that every person who has entered into a munitions contract shall keep detailed accounts and records of the cost of carrying out that contract and that on demand, they must produce to the authorized representative of the minister all the accounts and records relating thereto. If the records are such that the cost cannot be determined, the minister may fix an amount which, in his opinion, will represent the fair and reasonable cost of the work performed. In view of this, and because of the responsibilities involved in determining profits on war business, I feel that every chartered accountant should make it his business to encourage clients engaged in war work to keep their records in such shape that they will readily yield all the information on costs that may be required by the chief cost accountant of the treasury. You can be reasonably certain that sooner or later this information will be requested, and unless it is readily available, the contractor faces the possibility of having arbitrary values placed on his production. I can assure you that if you will see to it as auditors that your clients' accounts are properly set up and properly maintained, you will be rendering a real service to your clients, to the profession and to the country.

Audits and Cost Investigations on War Contracts

By F. E. Wood

Chief Cost Accountant,

Treasury Cost Accounting Division, Dominion Government

(Address at the annual meeting of The Dominion Association of Chartered Accountants, Toronto, 16th-18th August 1943.)

IN a recent issue of *Time*, reference is made to the recoveries by the U.S. government of some two billion dollars on contracts totalling eighteen and a half billion,

under renegotiation proceedings, with the pertinent comment that these results did not mean that the contractors had been inordinately greedy. I quote: "High productivity of labour, fine supervision, improved flow of raw materials, inexperience with costs and materials make many a company an unwitting profiteer. Only 10% objected to PAB's excisions. In some cases companies had bid high to protect themselves from unknown costs on unfamiliar products. In many cases the growing volume of orders and the experience gained in manufacture enabled companies to make huge unforeseen savings. In a few cases the contract price was figured on the costs of manufacturing a given weapon in Federal arsenals, and the companies had found ways of making big savings by simplifying designs and improving manufacturing technique."

In Canada very few manufacturers in 1940 or 1941 realized the tremendous effect on overhead costs of large volume production, and to a great extent our experience has paralleled that referred to above.

Mr. W. F. Williams, C.A., has already outlined to you the various types of contracts entered into by the Department of Munitions and Supply. Before going into the details of audit, may I review briefly the history of what is now known as the Treasury Cost Accounting Division.

The Treasury Cost Accounting Division

Shortly after commencement of hostilities in 1939, officials of the British Supply Board arrived in Ottawa to assist the War Supply Board, set up in Canada, in negotiating contracts on behalf of the United Kingdom, with Canadian contractors, for various types of munitions, most of which had never before been manufactured on this side of the Atlantic. Following experience gained in England since the last war, these United Kingdom officials introduced to Canada the "target" contract, under which the contractor was protected to the extent of his actual costs during the educational period, plus a sliding scale of profit with provision for bonuses in the event of cost being actually lower than the target set, and penalties should cost exceed the set target, but in no event reducing the profit below a fixed minimum.

In a lengthy memorandum prepared by Sir Henry Self, the historical objections to any form of cost plus contract

were reviewed as well as an explanation of the inevitability of using some form of a cost plus arrangement in cases where private contractors were asked to go into production, facing new problems of technical skill, engineering, machinery, and product. Experience has shown the target type of contract not only safeguarded the interests of both parties during the educational period, but also provided the basic data by which the negotiating officers could establish a fixed price that would be fair and reasonable for the bulk of the articles produced.

These target contracts, however, involved investigations and audit of manufacturing costs comprising the three elements, labour, material and overhead, not only for the results actually obtained, but also to ascertain the probable cost when the articles were being produced on an accelerated or full production basis. Sir Henry Self's memorandum stressed the necessity of the specialized accounting training required in the determination of these various factors, particularly overhead.

During the winter of 1939 and 1940, the British Supply Board Contracts Officer, Mr. A. C. Boddie, urged the War Supply Board to obtain the services of a cost accountant experienced in manufacturing costs, to investigate and report on this type of contract. An appointment was made by Order-in-Council, on March 1st, 1940, with the thought at that time that one person would be sufficient to conduct all cost investigations anticipated, at least for some considerable time. On April 9th, 1940, the Department of Munitions and Supply replaced the War Supply Board. Shortly after this date it became apparent that by law certain responsibilities rested on the Comptroller of the Treasury and the Auditor General, and if payments were made on the basis of audits carried out by the Department of Munitions and Supply, verification would of necessity have to be undertaken by staff of the Comptroller of the Treasury, with perhaps a third audit by staff of the Auditor General. I stress this point since in the early days of our Division, many business and professional men failed to recognize the dual function of the Treasury Cost Accounting Division which in fact provided against duplication of work and unnecessary staff, it being mutually agreed that the cost accounting work be transferred to the Comptroller of the Treasury, and that his staff would service the De-

partment of Munitions and Supply. This transfer was made in May 1940, when a separate section of the Treasury was set up by Mr. B. G. McIntyre to service Canadian, United Kingdom and allied contracts placed by the Department of Munitions and Supply, also to do such other cost accounting work for other government agencies or departments as might be required.

The magnitude of the task was not immediately apparent at that time but it was anticipated that the section might eventually require twenty or twenty-five of a total staff. It also became obvious that in addition to the target type of contracts on munitions, many other types of cost plus contracts were being entered into by the various branches of the Department of Munitions and Supply, and that some form of cost auditing would be required in almost every service and industry touched by war demands. Many contractors were dealing with more than one group of negotiating officers, so that uniformity of costing provisions was essential, if misunderstandings were to be avoided between contractors on the one hand and the various government agencies on the other.

A Basic Yardstick

Realizing the necessity of some basic "yardstick", after careful study of such information as was available on pre-war cost plus contracts in Canada, together with current procedure in the United Kingdom and the United States, a three-page mimeographed memorandum, entitled "Cost of Performing a Contract or Sub-Contract" was issued by the Department of Munitions and Supply, in September 1940, as Form No. M. & S. 433, later incorporated as part of the general contract conditions by Order-in-Council No. 6284.

Shortly after the Department of Munitions and Supply came into being, in April 1940, construction of the first pre-financed plant in Canada was started, followed almost immediately by several other plants on a similar financial basis in other places in Canada. This involved a radical departure from existing practice, in so far as disbursement of government funds were concerned, and it was necessary to evolve a procedure for audit and control of this type of project. When the Department of Munitions and Supply later created the Allied War Supplies Corporation, to super-

vise and operate the chemical and explosives projects, this procedure was included and amplified with the co-operation and assistance of the Auditor General, into the controls and audits now standard in all pre-financed government plants. In a pre-financed project, the entire operation is carried on by a management acting as agents on behalf of the Crown. Funds are provided by monthly budget, and a continuous running audit is required to verify disbursements and in conjunction with the Munition and Supply representative to see that all expenditures are proper.

Procedures were also evolved and developed for progress payments on construction work, aircraft overhaul, and repair depots, and other specialized types of cost plus jobs. With the assistance of a senior accountant from the British Admiralty, a special procedure was developed, known as an Emergency Repair Agreement, for repair and conversion of naval and other ships with every shipyard in Canada. Audit procedures and questionnaires for all specific audits of war orders were evolved and developed so as to standardize, as far as practicable, the treatment of each contract, and to provide the Auditor General with a working basis for such review and additional data as deemed desirable.

While a considerable volume of war contracts had been placed in Canada starting with the autumn of 1939, the pace did not really accelerate strongly until after the fall of France in June 1940. When the Department of Munitions and Supply was launched, its work consisted generally in purchasing from contractors with existing facilities, but after the event referred to, the tempo of its operations rapidly increased, and immense projects numbered in the hundreds were also undertaken to create facilities for production of munitions of every kind and type.

Highlights of Production

On June 11, 1943, Hon. C. D. Howe, speaking in the House of Commons, reviewed the detail production rates and deliveries to that date of various munitions of war. Some of the highlights were, each week:

- 6 or more vessels, escort, cargo or patrol, launched
- 80 planes
- 4,000 motor vehicles
- 450 fighting vehicles
- 940 heavy gun barrels or mountings

THE CANADIAN CHARTERED ACCOUNTANT

13,000 weapons from small arms plants
525,000 rounds of heavy ammunition
25,000,000 rounds of small arms ammunition
10,000 tons chemicals and explosives

and, to that date:—

500 ships launched
8,000 aircraft delivered
475,000 motor vehicles delivered
21,300 fighting vehicles delivered
55,500 heavy gun barrels or mountings
630,000 small weapons
800,000 tons chemicals and explosives
Instruments and communications to value of \$160,000,000
Total dollar value of deliveries $4\frac{1}{2}$ billion
Employment in war industry upwards of 900,000 men and women.

At the close of 1942 Canada was making 28 types of shells of 15 different calibres, in nearly 50 plants engaged in making shells alone. Scores of other plants produce components, including 12 types of fuses, 14 types of cart-ridge cases, two types of gaines, 6 kinds of primers, two types of depth charges, ten types of trench mortar bombs, pyrotechnics of 70 different kinds, as well as practice bombs, anti-tank mines and rifle grenades.

More than one fifth of the total government investment in war plants has been allocated to the production of guns and small arms. Canada is making 12 types of heavy ordnance and 16 types of carriages and mountings. Merchant ships and combat vessels made in Canadian yards can now be equipped with Canadian-made guns. Our field artillery, anti-aircraft guns, our tank and anti-tank guns, are being shipped overseas for service on all fronts.

One of the most important contributions Canadian industry has made to the war is our output of fighting vehicles and motor transport. More than 36% of the motorized equipment throughout the entire middle east in June was of Canadian make. Fifty percent of the load carrying vehicles used by Montgomery's victorious Eighth Army in Libya were Canadian made.

During the twenty years preceding the outbreak of this war, Canada built not one seagoing merchant ship. Up to the end of May 1943 this virtually new major industry in Canada had launched 168 cargo freighters, of which 141 had been delivered. All but 4 of these are 10,000 ton ships. Roughly, one half of the overall commitments for shipbuilding in Canada, which total one billion dollars, will be spent on cargo ship construction. Freighters delivered,

under construction or on order, in June totalled more than 300, of which 90% are 10,000 ton ships.

The Department of Munitions and Supply, General Purchasing Branch, handling most of the supplies required by the army, navy and air force, constitutes the biggest single market for hundreds of Canadian manufacturing plants. Orders placed by this branch total two and one half billion dollars. Its purchases range from pins to locomotives, from canned milk to fire fighting vehicles. It involves the buying of battle dress—50,000 a week and 5 million pair of footwear a year—the purchase of food, medical supplies, lumber, fuels, machinery, electrical equipment and miscellaneous stores, also raw materials for the finished products.

The 27 Crown companies referred to by Mr. Williams are audited by the Auditor General of Canada, and the Treasury Cost Accounting Division are only responsible for cost systems and controls of all projects operating under the supervising Crown companies, and to see that an adequate cost system is installed and maintained by the manufacturing or construction Crown companies. This last function in itself does not require a detailed cost audit, and is limited to a periodic examination in order to provide a sound basis on which to advise the management and the Department of Munitions and Supply as to whether or not adequate cost information is being obtained.

Accounting Firms Utilized

From the early days of the cost audit work the fullest co-operation and help has been extended by representatives of the public accounting firms in Canada. With the tremendous expansion in the munition program, the Department of Munitions and Supply found it necessary to rapidly extend the volume of sub-contracting so as to utilize to the full every available facility in Canada. These sub-contracts were placed by the main contractor, and through Order-in-Council 9159, dated the 26th November 1941, the Minister was given the right to audit such sub-contract work and to reduce the prices charged, if necessary, to the basis of such audited cost, plus a fair and reasonable profit.

Since it was apparent that the task of auditing the tremendous volume of these sub-contracts was beyond the limits of our available time and staff, it was decided to utilize the established accounting facilities which were readily

made available to the government through the auspices of the practising accountants, and auditors; in other words, wherever possible to use the sub-contractor's own auditors for determination of such costs. With the co-operation and assistance of Messrs. H. G. Norman and K. W. Dalglish, representing The Dominion Association of Chartered Accountants, regulations were drawn up under P.C. 455, authorizing the auditors of a sub-contractor to act on behalf of the Minister, when so directed, to audit and report the cost of the sub-contract work in accordance with M. & S. 433. These provisions have been used to a considerable extent, and the procedure in use will be referred to in detail later. In passing it may be of interest to refer to the volume of all prime contracts awarded, to give you some idea of the volume of work that has been placed on contractors, public accountants, and government auditors, as a result of the war effort. Not including letters of intention and unvalued acceptances of tenders, the figures are:—

	Number	Value in million dollars
1939	4,425	\$ 66
1940	70,649	1,147
1941	167,167	2,079
1942	254,189	3,504
1943 to June 30 (Est.)....	128,448	2,121
Total	<u>624,878</u>	<u>\$8,917</u>

These figures do not include sub-contracts, nor do they represent only orders subject to cost audit. However, this analysis indicates the trend of expansion in industry, and the ratio of purchases on which some form of cost audit is required, has remained surprisingly high.

During the same period the staff of Munitions and Supply has increased from three in July of 1939 to more than five thousand today, and incidentally do not include the staffs of the Crown companies referred to, although they are operating actually as branches of the Department of Munitions and Supply.

With the diversity of cost audits spread from Newfoundland and Labrador on the East, to Vancouver Island on the West, and the tremendous increase in the extent and volume of the duties falling on the Cost Division, it became imperative in the interests of efficiency and economy to open branch offices. In 1940 branches were established in Tor-

onto, Vancouver and Victoria in July: Saint John, New Brunswick in December: and in 1941 at Montreal, in March; Winnipeg in May, and Halifax in October. In 1942 a small office was opened in Calgary.

Including supervisors, senior, intermediate and junior accountants our staff at present comprises about 325 accountant officials. Of these 39 hold the degree of C.A., 13 the Cost Accounting degree of either R.I.A. in Ontario or L.C.M.I. in Quebec, 3 C.P.A., 4 C.G.A., 1 A.P.A. and 4 Chartered Institute of Secretaries.

Most of the degreed men were drawn from industrial life and very few came to us from a public accounting firm. The bulk of our staff have had practical cost or general accounting experience for many years in various types of industry and have taken some form of accounting training either in public accounting firms or through study courses, etc.

In view of the wide scope of this work and the variety and complexity of the problems encountered we do not expect to have any one individual who can satisfactorily solve all accounting or cost accounting problems. Rather we have endeavoured to build up a staff qualified and experienced in their respective fields, so that within our organization we can competently deal with any matter within the range of our duties and responsibilities.

In passing it may be of interest to mention that our organization has been subdivided roughly into six main divisions, namely, aircraft, construction, munitions and general, shipbuilding and ship repairs, textiles, and mining projects. Each section is in charge of a chief at Ottawa with supervisors as necessary in the field and at the various branch offices.

Our work is by no means completed when we approve an audit report and forward it to the negotiating officer concerned. As a result of the experience gained on various types of contracts during the past three and one half years, our senior officers are in constant demand to sit in on negotiations and renegotiations in an advisory capacity.

Co-operation with United States

Shortly after the U.S.A. entered the war, we were requested to supply copies of our costing memoranda, audit procedure, etc., to the authorities at Washington. This

was followed by visits from officials of the Price Adjustment Board, War Department and Navy Department, auditors who made an intensive study of the experience gained in Canada along these lines since 1939. We were, of course, very happy to co-operate fully with these officials and to learn from them the policies adopted by the U.S. government for purchases in that country. From such information as we have been able to obtain, the costing basis is identical in principle and very similar in practice, with perhaps more emphasis in Canada to ascertaining the basic facts from test checks and verifications to eliminate as far as possible, undue detailed checking of accounts. Originally the U.S. adopted very rigid and elaborate control procedure involving a much larger government staff per unit than was available in Canada, but latterly I understand this has been greatly simplified of necessity due to shortage of qualified accounting staff.

In the limited time at our disposal it would obviously be impossible to attempt to cover the variations in audit procedure necessary for each type of contract, although the general principles involved are similar in all cases.

Work of the Public Accountant

I have, therefore, selected for our discussion the work of the public accountant in carrying out cost audits on sub-contract work. The procedure is almost identical with that of our own staff on specific audits and is, therefore, representative of a large portion of our work.

At the conclusion of this paper, with the chairman's permission, I shall be glad to answer, within my power, any questions either in regard to this phase of cost audits on war contracts or in regard to the Cost Accounting Division's activities generally.

Sub-Contract Audit Procedure

Prime contractors working under any form of cost plus fixed fee or similar arrangements are requested by D.M.S. to furnish a list of sub-contracts entered into, under the particular prime contract in question, during a given calendar year, with the following information:

Name and address of sub-contractor

Sub-contract number, if any

Type of article or work to be performed

Approximate value of billings for the year

AUDITS AND COST INVESTIGATIONS ON WAR CONTRACTS

Approximate total value of sub-contract

Approximate final delivery date

Following receipt of this data which is collated to show all such work being done by a given sub-contractor, the following circular is forwarded to the sub-contractor. (Exhibit A).

Exhibit A

**DEPUTY MINISTER OF MUNITIONS AND SUPPLY
OTTAWA, CANADA**

Dear Sirs:

Re: Sub-Contract Work on Government Contracts

We are advised that you have carried out, or are carrying out, work as follows:

Main Contractor Name & Address	Contract No. or Description	Your 1941 Billings (Approximate)	Estimated Total Billings
-----------------------------------	--------------------------------	--	--------------------------------

.....
.....
.....

For your information, we are attaching a copy of Order-in-Council No. 9159 which you will note stipulates that the Minister may require an audit, etc., of your costs on this work.

In order that such audit may be carried out with the least inconvenience to you, it may be possible to arrange for the services of your regular auditor to investigate and report your costs and profit margin on the particular work involved.

Should we request such special audit to be performed by your auditors, the cost of such audit will be paid for by the Government, and will not be a charge to you.

As you will doubtless be glad to co-operate in order to get this essential work completed as promptly as possible, will you kindly advise by return mail the name and address of your auditors.

Yours very truly,

WM. F. WILLIAMS,
Executive Assistant.
(Financial)

On receipt of his reply the Department then issue the following unless it is decided to have the audit performed by Treasury Cost Accounting Division as for example when the firm in question is already being audited by our staff. (Exhibit B).

Exhibit B

File:
Date:

RE:

Dear Sir:

We have been advised by the above Company that you are its auditor. The Company is engaged in carrying out the following sub-contract:

Prime Contractor	Locale of Work	Subject Matter
.....
.....
.....

THE CANADIAN CHARTERED ACCOUNTANT

and its costs of carrying out such sub-contract are subject to audit on behalf of this Department.

It is our desire that such audit be made and that the costs of carrying out of such contract be investigated and established by you pursuant to Order-in-Council P.C. 455, a copy of which is enclosed.

Your statement regarding the costs of carrying out the work must be made up in conformity with the Departmental Costing Memorandum, Form M & S 433, and your investigations should be conducted along the lines laid down by Mr. F. E. Wood, Chief Cost Accountant, Department of Munitions and Supply. You are, therefore, requested to communicate immediately with Mr. Wood, whose address is 375 Wellington Street, Ottawa, who will advise you in detail as to the information required. After your investigations are completed, your report should be made to Mr. Wood, and all working papers in connection with your investigation should be forwarded to him.

I should be obliged if you would forward to me, in order to complete my file, a copy of your letter to Mr. Wood.

Your attention is drawn to paragraph (3) of P.C. 455 enclosed herewith, which provides that your reasonable remuneration for performing the services herein referred to will be paid by the Crown.

It is understood that the right is reserved to the Honourable the Minister of Munitions and Supply to make such independent investigations and inquiries as may be deemed advisable.

Yours very truly,

WM. F. WILLIAMS,
Executive Assistant.
(Financial)

On acknowledgment by the auditor the Treasury Cost Division then write the auditor. (Exhibit C).

Exhibit C

To Company Auditors

Subcontract Work	Re: Subcontractor— Prime Contractor	Nature of Work
Gentlemen:		

In reply to your letter dated, I am enclosing in duplicate, Audit Instruction, Cost Audit Questionnaire and M & S Form 433, which will afford you essential information necessary to carry out this audit.

It is suggested that insofar as possible, your report should cover the total requirements of the designated prime contract. In the event that the subcontract did not terminate prior to the close of the subcontractor's last fiscal year, then your audit should cover a period which will coincide with the closing date of the nearest complete accounting period. If an interim audit is contemplated, then kindly communicate with us before proceeding. Your letter should set out pertinent facts and information to enable us to instruct you as to the advisability of carrying out the audit prior to the completion of the work.

After consulting with your client, will you please advise when it is your intention to conduct the necessary cost audit, what period will be covered, and your estimate of the time and expense involved. Any correspondence regarding these points should be addressed to this office.

In submitting the results of your cost audit, it will be necessary for you to issue a separate report, covering the sub-contract costs applicable to each prime contract. . . . copies of these reports should

AUDITS AND COST INVESTIGATIONS ON WAR CONTRACTS

be submitted with your working papers through our office.

Should you wish any further advice during the course of the audit, I would refer you to our District Supervisor whose address is

Yours very truly,
for F. E. Wood,
Chief Cost Accountant.

In the May issue of the Canadian Chartered Accountant, Mr. Harry E. Clayton, C.A., of our Toronto supervisory staff, outlined in some detail the practical application of these instructions in the field by a public auditor, under the title "General Observations Concerning Cost Investigation Procedure". At the risk of repetition I would like to emphasize one of two points brought out in this paper.

The fundamental difference between a cost investigation and a balance sheet audit is that the work undertaken resolves itself primarily into an examination of a specific phase of the contractor's accounts and records, rather than a detailed overall verification.

As a first step, a brief examination of both the plant and product to be costed will repay the investigator ten fold for the time thus spent, in providing a background to aid him in forming general opinions as to whether the cost allocations are equitable.

Productive material charges accumulated on a stores issue or bill of material basis should be verified by a physical test check of component parts with due allowance for scrap and rejects.

Perhaps the most important and incidentally the most difficult, is equitable allocation of overhead in plants engaged concurrently in war and commercial work. A straight productive labour basis, is of course, full of pitfalls and if adopted in toto, in many cases would be most unfair to either the contractor or the Department. Therefore, we endeavour to deal with each audit on its own merits and to apply whatever basis or combination of bases seem most equitable in the light of our experience and best judgment.

A few months ago I read the reports of a Committee on War Expenditures for the Union of South Africa. Their final report emphasized that the benefits which accrue to industry as a result of their being made more cost conscious will be equally as apparent in peace time as in war, and that no private contractor in his own long term view can afford to disregard cost control and maximum working ef-

iciency regardless of the terms under which his organization is carrying out war contracts.

In Canada, prior to the war, and I believe to a similar extent in other parts of the world, the cost accountant in industry was more or less ignored or at least not given the full recognition by management that his services demand. The impact of war contracts inevitably subject to close cost scrutiny has immeasurably emphasized the importance of this branch of accounting. In the great task of reconstruction and rehabilitation of private industry that lies before us as soon as present hostilities are successfully terminated, the manufacturer who best knows his costs will be the most likely to succeed, other things being equal. For the business man of today and tomorrow I feel you may safely counsel that to be cost conscious is a dividend paying policy of prime importance.

To return to our audits on war contracts please do not hesitate to let us have any time your suggestions and constructive criticism. They will be cordially received and carefully considered.

In conclusion I would like to express a hope for a continuance of the cordial relations and full co-operation which has existed between The Dominion Association of Chartered Accountants and the Treasury Cost Accounting Division since it was formed, to the end that together we may accomplish the maximum of results with minimum of effort and cost to the public purse.

Exhibit D

March 3, 1942

DOMINION OF CANADA
DEPARTMENT OF FINANCE—COMPTROLLER OF THE
TREASURY BRANCH

Treasury—Cost Accounting Division
Audit Instructions

(to be used regarding the audit of sub-contracts, conducted by independent auditors by virtue of the authority granted under Order-in-Council—P. C. 455).

It is essential that a permanent record of all audit work be maintained—therefore, when carrying out a Cost Investigation always remember that you on the job have all the information—so as a matter of record provide all essential information.

To this end and as a guide to the audit staff, the following has been prepared:—

WORKING PAPERS

For uniformity and convenience in review, working papers should be clear and concise and indexed alphabetically, as follows:

A.A. Finished Papers

B.B. General Data—This will include:

AUDITS AND COST INVESTIGATIONS ON WAR CONTRACTS

1. Cost Audit Questionnaire (Programme) and General Notes.
2. Extracts from Contract or Acceptance of Tender, etc.
3. Interviews with Company representatives.

- A. Labour
- B. Material
- C. Overhead.

Additional letters may be used to indicate Production Reports, Inventory data or such other matters as may be of substantial volume and importance.

Further to the above, all sheets should be numbered consecutively under the respective letters, with the first sheets reserved in all cases for summary, adjustments, and conclusions.

In compiling finished papers on an audit, the final figures should be "keyed in" from the source from which they are brought forward. Strict adherence to this practice in respect to all important figures greatly reduces time required for final review and future reference by senior officers.

The working papers should include the cost summary and supporting schedules supplied by the sub-contractor, and a reconciliation with the costs as determined by you. Our principal function is to examine and audit—not to compile cost records. The sub-contractor should be informed as to what is required from him and the audit work should commence when such figures have been submitted by him. At the completion of the audit it is advantageous to have the sub-contractor concur in the findings.

In compiling working papers, it is essential that your analysis should not only show differences due to extraordinary costs, but that satisfactory explanation should be obtained and recorded in the working papers to explain the reasonableness of allowing (or disallowing) questionable items.

COST AUDIT QUESTIONNAIRE

Since we are required to forward to the Auditor General's Department the completed Cost Audit Questionnaire, it is necessary that all questions be answered. If the questions asked do not apply, some notation to this effect should be inserted.

FINISHED REPORTS

1. Preparation of finished reports is the most important phase of the work of the audit staff. In order to do justice to the effort expended in the detail examination of costs, the greatest care should be exercised to set down the results of the audit in a clear and concise manner, readily understandable to the negotiating officers and other interested persons.
2. Reports should be prepared in accordance with the terms of the sub-contract and as required under the conditions of M & S Form 433. In connection with the latter and contentious matters arising therefrom, please refer directly to the Chief Cost Accountant for opinions and rulings. Verbal inquiries, on routine matters, may also be directed to any of the Supervising Cost Accountants located at the Cost Division Branch Offices in Calgary, Halifax, Montreal, Toronto, Winnipeg and Vancouver. However, all requests for final rulings from the Chief Cost Accountant should be held in abeyance until the completion of the audit at which time a written request should be made to him at Ottawa.
3. The finished report should show final costs under the following headings:—
 - (1) Labour
 - (2) Material
 - (3) Overhead

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(Note) Special Depreciation (War Contracts Depreciation Board Awards) must be shown as a separate item under this heading.

Additional headings may be shown for items which cannot be properly classified under any of the above headings, e.g., freight out, sales tax (if any), etc.

4. The finished report should be concluded by the Auditor's certificate which should be worded as follows:—

"I hereby certify that, in accordance with the authority provided under Order-in-Council P. C. 455. I have made an examination of the accounts and records of the sub-contractor insofar as they pertain to the above production (Description of article may be inserted if practical), and I have received all the information and explanations I have required, and that (if qualifications are necessary put in here 'subject to') the amount of \$..... per is the fair cost thereof arrived at by the application of the principles laid down by M & S Form 433 as shown by the accounts and records and the information and explanations given to me."

The auditor's certificate contained in the report may be qualified as indicated above wherever exception is taken either to the method of computing costs which have been submitted for audit or in the amounts as reflected in the final figures contained in the report.

5. Where it is not possible to give a certificate due either to lack of adequate records or for some other good reason, then no attempt at certification should be made. However, adequate reasons for inability to certify should be stated in the finished report.
6. In addition to the summary of cost (see 3 above), it is requested that the finished report contain the billing price, exclusive of freight out and sales tax charged in invoicing to the prime contractor, as shown by the records of the sub-contractor, and verified directly with prime contractor.
7. In addition to the certificate which is required from the independent auditor, it is also necessary for the Chief Cost Accountant to attach an additional Certificate or approval. Since this work involves a certain amount of analysis to be done by Cost Division senior officers, it is necessary that all relevant information and working papers accompany the original report.

GENERAL

The co-operation of all outside auditors is sought in obtaining uniformity in the preparation of working papers. It will expedite matters to follow a procedure which will lend itself readily to interpretation and which is common to all.

It is not intended that the auditor should take on the functions of "Production Engineers", but on every investigation the Accountant should take note of whether or not the plant seems to be running efficiently. Where considered necessary, a separate memorandum on this point should be sent in with the working papers and especially where there is any evidence of increased production costs due to inefficiency. Reference may be made through the Chief Cost Accountant either for the assistance of a Senior official of this Division who is versed in these matters, or to the Production Branch of the Department of Munitions and Supply for other technical advice, if and when required, prior to the issuance of the final report. If the costs appear excessive, qualification should be made in the certificate to deal with the cost factors which are considered to be not properly

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determinable (reference to production of like articles by other manufacturers may form a guide in the judging of such matters).

In some cases it may be desirable to refer questionable points to the Chief Cost Accountant for opinions and rulings; also this assistance is to be taken advantage of at all times in order that difficult situations will not develop to affect the position of the auditor with his client.

F. E. Wood,
Chief Cost Accountant.

Exhibit E

M & S 433

COSTING MEMORANDUM

The general rule is that the cost of performing a particular contract shall consist only of expenditure made by the contractor in connection with the contract, and shall be the sum of—

- (1) Direct Materials
- (2) Direct Labour
- (3) Direct Expenses
- (4) A proper proportion of applicable indirect cost (including a reasonable proportion of management expenses).

GENERAL ELEMENTS OF COST

No definitions of the elements of cost may be stated which are of invariable application to all contractors, but in general the elements of cost may be defined as:—

- (1) Manufacturing Cost
 - I Direct Materials
 - II Productive Labour
 - III Direct Engineering Labour
 - IV Miscellaneous Direct Factory Charges
 - V Indirect Factory Expenses
 - VI Other Manufacturing Cost

See "Particulars"
for further explanation of these items.

- (2) Miscellaneous Direct Expenses
- (3) Miscellaneous Indirect Expenses

BUT THERE SHALL NOT BE INCLUDED AS COST OF THE FOLLOWING:—

- (1) Allowances for interest on invested capital, bonds, debentures, bank or other loans.
- (2) Entertainment Expenses.
- (3) Dues and other memberships other than regular trade associations.
- (4) Donations (except as stated in Section 3, Subsection (b) hereunder).
- (5) Losses on other contracts.
- (6) Losses from sale or exchange of capital assets.
- (7) Depreciation on buildings, machinery or equipment paid for by the Crown.
- (8) Fines and penalties.
- (9) Amortization of unrealized appreciation of values of assets.
- (10) Expenses, maintenance and/or depreciation of excess facilities.
- (11) Increases in reserves for contingencies, repairs, compensation insurance and guaranteed work.

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- (12) Federal and Provincial income, excess profits or surtaxes.
- (13) Unreasonable compensation for officers and employees.
- (14) Bond discount or finance charges.
- (15) Premiums for life insurance on the lives of officers.
- (16) Legal and accounting fees in connection with reorganizations, security issues, or capital stock issues.
- (17) Losses on investments, bad debts and expenses of collection.
- (18) Advertising and selling expenses.

PARTICULARS

1.

I DIRECT MATERIALS

Includes, in addition to materials purchased solely for the contract and processed by the contractor, or material obtained from sub-contractors, any other material purchased for stock which may subsequently be used and becomes a component part of the contract.

All materials shall be charged to the contract at the net laid down price after deducting all discounts and other similar items.

Cost shall be credited with the fair market value of all scrap produced from materials charged to the contract, either in manufacturing processes, rejects, due to design changes, or from any other cause.

II DIRECT LABOUR

Production labour which is performed directly on and is properly chargeable to the contract.

III DIRECT ENGINEERING LABOUR

Compensation of professional engineers and draftsmen properly chargeable to the contract.

IV MISCELLANEOUS DIRECT FACTORY CHARGES

Items properly chargeable direct to the contract, but which do not fall within any of the above categories. As an example, a royalty payable.

V INDIRECT FACTORY EXPENSES—"Factory overhead or burden"

- (a) Labour: supervision and inspection, clerical, timekeeping, stores tool crib, cleaners, watchmen, etc.
- (b) Materials and Supplies: shop fuel, lubricants, waste, non-durable tools and gauges, etc.
- (c) Service Expenses: expenses of a general nature such as power, heat, light, operation and maintenance of general plant assets and facilities.
- (d) Fixed Charges: recurring charges such as property taxes, rentals and provision for depreciation. In making provision for depreciation, consideration may be given the number and lengths of shifts, but the provision shall not be inconsistent with the regulations imparted by Commissioner of Income Tax.
- (e) Miscellaneous Indirect Factory Expenses: items not directly chargeable to the contract, such as purchasing expenses, employees' welfare, employer's payments to any Federal unemployment or health funds but shall not include
 - (1) Payments deducted or chargeable to employees
 - (2) Pension and retirement payments.

VI OTHER MANUFACTURING COSTS

Includes items not properly or satisfactorily chargeable to factory costs, but which, upon a complete showing of all pertinent facts, are properly to be included as a cost of the contract, such as:

Experimental and development charges.

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2. MISCELLANEOUS DIRECT EXPENSES

Sundry items: fees paid for tests, travelling expenses applicable to the contract, etc.

3. MISCELLANEOUS INDIRECT EXPENSES

(a) Indirect engineering expense "Engineering Overhead" consisting of labour, materials, and miscellaneous expenses.

(b) Administrative expenses including salaries of corporate and executive officers, office salaries, janitors, cleaners, miscellaneous office and administrative expenses, such as stationery and office supplies, postage, normal contribution to local charities and other necessary office expenses.

ALLOCATION OF INDIRECT COSTS

No general rule is applicable to all cases. The proper proportion of indirect costs chargeable to the contract will depend on the ascertaining of all facts and circumstances relating thereto, subject, however, to a requirement that all items which have no relation to the contract shall be eliminated from the amount to be allocated.

Provided the articles produced from the contract are of the same general class as the concurrent production of the plant, then allowable indirect expenses may be distributed on the basis of the proportion which the direct productive labour on the contract bears to the total productive labour of the particular section wherein the contract work may be carried out, except that if indirect expenses are incurred in different amounts and in different proportion by the various producing departments, consideration shall be given to such circumstances to the extent necessary to make a fair and reasonable determination. Administrative and other general expenses may be dealt with in a like manner.

In cases where the product is essentially different to the concurrent production, indirect costs wherever possible shall be segregated and the proper items thereof charged direct to the contract.

ACCOUNTS

Contractors' accounts shall be kept in such a manner as to clearly disclose the nature and amounts of the different items of cost pertaining to the contract, and all records of original entry must be preserved in form available for ready reference until released for disposal by the Minister.

Exhibit F

Editor's Note—In this questionnaire, the parts of the questionnaire itself are printed in Roman type. The speaker's comments are reproduced in *italic* type.

March 3, 1942

DOMINION OF CANADA DEPARTMENT OF FINANCE — COMPTROLLER OF THE TREASURY BRANCH

Treasury—Cost Accounting Division COST AUDIT QUESTIONNAIRE

(To be used regarding the audit of sub-contracts, conducted by independent auditors by virtue of the authority granted under Order-in-Council—P. C. 455).

This Questionnaire should be completed and returned to the Chief Cost Accountant together with any further comments which may be deemed necessary information in connection with the audit work performed.

This cost audit questionnaire does not limit the work to be per-

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formed in examination of costs, or supersede the information and cost finding reports to be written and certified to the Chief Cost Accountant. The questionnaire embraces information and verification requirements only; it will form a report on the programme carried out in examination of costs, and generally will ensure that all questions which may concern costs are reviewed and dealt with. In necessary cases, however, the field audit must be expanded to obtain any supplementary essential information and such additional work should be recorded under the appropriate title on separate sheets to be attached at the end of the questionnaire.

The sub-contractor will be requested to prepare and submit cost statements together with any supporting schedules and it should only be necessary to audit such prepared costs in carrying out the field audit—if more than this is deemed necessary, separate authority must be obtained before proceeding at length.

In addition to this Questionnaire it is imperative that adequate working papers should evidence the audit work performed, the information and explanations obtained and the method by which the final results are obtained. In this connection please refer to "Audit Instructions" memorandum for further information.

In some cases it may be desirable to refer questionable points to the Chief Cost Accountant for opinions and rulings prior to the issuance of the final report; also this assistance is at all times to be taken advantage of in order that difficult situations will not develop affecting the position of the auditor with his client.

F. E. Wood
Chief Cost Accountant

GENERAL INFORMATION

Name of Sub-Contractor Place	Name of Main Contractor Place
---------------------------------	----------------------------------

1. Reference—

- Cost Division File No.
- Order No. from Prime Contractor

Our own filing system includes only orders subject to Cost Audit. Contractor's order number necessary for complete cross reference; corresponds with D.M. & S. contract numbers on other Cost Section requests for audit.

2. Terms of Sub-Contract—

- (a) Cost Plus
- (b) Firm Price
- (c) Specify general nature of production and approximate amount

Various types of contracts present different types of problems, hence a pre-knowledge of type is useful both for purpose of field auditor and the reviewer. Firm price vs. Cost Plus only necessary on subcontract audits since the former are subject to Cost Audit as well as the latter, under P.C. 9159.

3. Has Sub-Contractor received capital assistance

- (a) from the Government
- (b) from the main Contractor

Financial assistance by either Government or Prime Contractor has distinct bearing on costs and must be studied carefully in finalizing audit. Costs of Capital Assistance items must be accounted for separately with special attention directed to assets "of subcontractor's own manufacture".

4. Sub-Contractor's Officials Interviewed:

AUDITS AND COST INVESTIGATIONS ON WAR CONTRACTS

- | Names | Positions |
|---|------------------------|
| <i>Required for future reference.</i> | |
| 5. Cost Investigation— | |
| (a) Date authorized | |
| (b) Date begun | |
| (c) Date completed | <i>Total</i> |
| (d) Staff engaged on this work | <i>Number of Hours</i> |
| Name of Senior in Charge | <i>on this Audit</i> |
| Number of Seniors— | |
| Intermediates— | |
| Juniors— | |
| <i>Required for Administrative purposes.</i> | |
| 6. Period in which costs incurred— | |
| (a) Date begun | |
| (b) Date completed | |
| Was definite cut-off made | |
| <i>Required for tie-in with financial statements and indication of extent of time required to complete subcontract work.</i> | |
| 7. The Sub-Contract— | |
| Have you examined an authentic copy of the Sub-Contract and obtained authoritative interpretations of clauses not clearly understood. | |
| <i>Contractual relationship should be ascertained and carefully observed. D.M. & S. Legal Department are at all times most co-operative in furnishing authoritative opinions (without charge!).</i> | |
| 8. Records and Accounts— | |
| (a) Are the cost and other records examined by you part of the general books of account. | |
| (b) Are the cost records adequate. | |
| (a) Inserted primarily to place responsibility on field auditor to see that authentic records are presented for his examination. | |
| (b) Requires expression of opinion on part of investigator and provides basic information concerning extent of certification and for qualification. | |
| 9. What type of cost records were maintained— | |
| Job Costs | |
| Process Costs | |
| Standard Costs | |
| <i>N.B. Cost Section do not insist on any particular type of Cost System nor does Costing Memorandum M. & S. Form 433 imply that Job costs are necessary—Such an impression for a time seemed widespread.</i> | |
| 10. Financial Statements— | |
| Did you reconcile the profits shown on this work with the financial statements and correlate same with the profits made on other Government work. | |
| <i>Not always possible to comply with this query. U.S. Government officials showed special interest in this feature on the occasion of their first visit to examine our procedures. Where not possible, overall approach often necessary in order to prove cost figures to be reported.</i> | |
| 11. Have you satisfied yourself that the material, stores, and payroll accounting systems, particularly the distribution of charges to this work are such as to prevent the loading of production costs with amounts properly chargeable to other production. | |
| Is method of allocation of Overhead Charges consistent with the sub-contractor's usual practice (Cross reference to working papers). | |
| <i>Primarily inserted as a safeguard to protect Government Contract</i> | |

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Costs from being overloaded through inconsistencies in the Contractor's System or deliberate padding of costs by unscrupulous persons—not a problem in most audits. Overhead problem is different and calls for discretion of the cost auditor in order to equitably spread such charges in a manner consistent with the Company's practice and good accounting principles.

12. Have you prepared reconciliation between the costs allowed by you and the costs as claimed by the sub-contractor (cross reference to working papers).

Necessitated in order to localize problems and iron out differences on the spot and thus save time of Contractors and their accountants, to say nothing of the elimination of a major time loss to senior officers of Cost Section in trying to answer questions of which we have not always a first hand knowledge.

13. (a) Have you any knowledge that there have been received or may have accrued any commissions, discounts, rebates or allowances which should be applied in reduction of the costs under audit.

- (b) Is a separate Certificate necessary in order to verify in a satisfactory manner.

(a) Originally inserted to assure credit to Government Costs for reductions accruing from miscellaneous sources as indicated particularly in respect to peace-time practices such as quantity discounts, year-end purchases, dividends or bonus payments and confidential discounts.

Factor not as significant today as earlier periods.

(b) Certificate only necessary in cases where such discount, etc., does not form a part of the accounts and records subject to audit, e.g. Rebate payable to an associated Company or Commission payable to an individual.

14. Is Sub-Contractor a subsidiary of or allied with the prime contractor.

Specify—

Relationship of manufacturers should be known in order to guard against hidden profits on inter-company transactions—this information is also required under the terms of certain Government contracts.

15. Sub-Contracts—(In the event that any work under this sub-contract has been sublet, please complete this question.)

- (a) State names and addresses of sub-contractors.
(b) State approximate amounts of sub-contracts.
(c) Have sub-contractors' accounts and records been examined.
(d) Are sub-contracts on—firm price
cost plus

If latter, give details.

- (e) Are any sub-contractors subsidiaries of or allied with prime contractor, or the main sub-contractor.

If so, give details.

Questions only to be completed in the event of sub-sub-contracting of work by him in which case similar information is required to that asked for in other contracts.

SCOPE OF EXAMINATION

Wherever possible, answer the question hereinafter by "yes" or "no" and by stating the extent (%) of examination.

- (1) Did you go through the plant to familiarize yourself with steps in the operation and, where possible,
(a) Prepare production line chart
(b) Note number of employees engaged

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- (2) Have you examined production reports and is there a schedule thereof in the working papers.
- (3) Do you consider spoils and rejects to be normal.
- (4) Has Certificate of Approval been furnished by Production Division or Inspection Representative of either the main Contractor or the Government.

Specify—

Information essential for Departmental purposes.

(1) Not necessary in small audits unless auditor unfamiliar with production subject to Cost Audit. Company's auditor usually has fair knowledge. Required wherever large-scale munitions, e.g., Shells, Fuses, Guns, etc., is undertaken. Not always available as for instance where production is "secret".

(2) Usually contractor on Munitions has to keep D.M. & S. Production Branch advised of weekly progress, quantities, etc.—regular forms developed for this purpose. Such Schedules not provided in case of ordinary supplies of regular production type.

(3) Experience on other jobs of similar nature is often available—otherwise opinion of competent engineer or production man should be sought.

(4) Cost Section requires certificate on Capital Expenditure audits in order to comply with Section 30 of the Consolidated Revenue and Audit Act.

In case of production audits delivery of the goods in a state satisfactory for acceptance obviates necessity for such a certificate. Nevertheless Production Branch of Department maintain close scrutiny of the condition of delivered goods and Cost Auditor can ascertain valuable information through consultation concerning same with properly authorized persons.

DIRECT MATERIALS

- (1) Materials charged through stores—
 - (a) Are there separate receiving and stores departments for materials purchased for this work.
 - (b) Were materials charged to contract at net laid-down cost.
- (a) No comment.
- (b) Replacement cost not admissible although often sought in certain industries.
- (2) Materials charged directly from Purchase Invoices
 - (a) Were all materials charged in this manner
 - (b) Was inventory of Excess Materials taken on completion of production.
- (a) No comment.
- (b) Any excess materials claimed as a charge to costs should be separately inventoried, and if allowed, should become property of Government.
- (3) Did you test check back to Purchase Invoices the principal materials charged to the contract.

Test check is limited at the discretion of field auditor but it should not exceed 20% to 25% unless irregularities are disclosed—ordinarily, extent of check should be very much less.

- (4) Did you test check
 - (a) Invoices to entries in Purchase Journal
 - (b) Stores issues to requisitions
- (a) Limited test check—See above.
- (b) Limited test check—See above.
- (5) Were you able to make any cross check on the materials charged against the material set out in specifications, taking into account rejects and scrap.

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Very important test and on anything other than complex products is one of the easiest methods of proof. Will save many days detail checking of book work.

- (6) Are detailed records of scrap, etc., maintained by which disposal of such materials can be checked.

Unless scrap is very nominal, separate records should be kept, especially if materials are expensive such as brass, etc.

- (7) *Scrap and Salvage—disposal*

(a) Did you check amounts credited to costs against selling prices as shown on invoices or other data.

(b) Were you satisfied that the prices obtained were reasonable.

(c) Were selling prices in accordance with Government regulations. (e.g., Steel Controller, etc.)

(a) Tie-in essential if costs are to be properly credited. Adjustment necessary to conform with findings under (6).

(b) } Metal prices should conform with Government regulations.

(c) }

- (8) Did you ascertain that materials were taken into the costs only after allowances for all Trade Discounts, Cash Discounts, Rebates, Commissions and Scrap.

No comment.

- (9) Did you review inventory prices at end of production period to verify that they were not on a lower basis than the materials charged to the work.

Essential for proper determination of material costs irrespective whether deductible or claimed as additional as under (2).

- (10) Does Sub-contract contain Escalator Clause on Materials

(a) Have these charges been excluded from costs

(b) Has separate claim been prepared.

(a) Non-allowable and separately recoverable if provided for in contract.

(b) Costs subject to verification by Cost Accountants in accordance with terms of contract and strict interpretation of escalator conditions which have been developed on more or less of a standard basis so that they will lend themselves readily to interpretation. In this connection it is interesting to note that all such clauses contained in D.M. & S. contracts are submitted for review and approval by the Chief Cost Accountant.

DIRECT LABOUR

- (1) Did you verify the labour charged to the costs by test check to

(a) Time-clock cards

(b) Distribution of job allocation slips

(c) General payroll distribution

(a) } Minimum test check to be performed at discretion of field

(b) } auditor and to be limited except where irregularities are dis-

(c) } closed.

- (2) (a) Did you test check extensions and additions of above

(b) Did you test hourly rates of pay or average piece-work earnings.

(a) } Same requirements as in (1).

(b) }

- (3) What basis of wage payment is in force:

(a) Piece-work

(b) Straight time

(c) Overtime allowance

(a) } No comment.

(b) }

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(c) Should be checked for consistency with other Commercial practice.

(4) Is any production incentive plan followed (i.e., bonus)

(a) on this work

(b) on Company's usual production.

(a) } Investigation frequently discloses variance in Company's

(b) } practice as between say—Cost Plus vs. Fixed Price Contracts.

(5) Are overtime bonus or premium wages charged to—

(a) Direct Labour, or

(b) Overhead Costs

(a) Permissible only if normal compared with other production.

(b) Preferable method in order to obtain equitable distribution and avoid overloading of production which runs overtime—actually a saving.

(6) Does Production Labour Cost include any charges for—

Superintendence

Foremen

Employees who are not machine operators or otherwise directly engaged in assembling the production.

Inspection

Idle Time.

If so, specify—

Exclusions should be made for any items which are not wholly consistent with standard Company practice for determination of Overhead Loading base.

Frequent irregularities found on investigation. Also additional inspection requirements, etc., make it imperative to reduce base figure to corresponding level with Direct Labour on Commercial work.

(7) (a) Is method of allocation of labour charges to this work consistent with the Company's usual practice on other jobs and commercial work.

(b) Is distinction between Direct and Indirect Labour as applied to this work consistent with Company's usual practice for commercial work.

(a) } Necessary for purposes of applying and ascertaining proper

(b) } overhead costs.

Did you test check payroll records to substantiate these points.

No comment.

(8) Is this sub-contract operating separately

(a) How many shifts operated on work

(b) Approximate number of men per shift

(c) Approximate date labour efficiency was reached

(d) Weekly rate of production at that time

(a) } No comment.

(b) }

(c) This does not mean 100% efficiency—auditor's opinion can be based on his own knowledge and information available.

(d) No comment.

(9) Does sub-contract contain escalator Clause on Labour.

(a) Have these charges been excluded from costs

(b) Has separate claim been prepared

(a) Non-allowable and separately recoverable if provided for in contract.

(b) Costs subject to verification by Cost Accountant as in case of materials (see Direct Materials, item 10B).

It should be noted that escalator operates as against the base rates. In other words, if overtime is paid, the escalator provision only applies to the straight time portion and therefore excludes the overtime pay-

ment premium, except to the extent which it applies to the increase in base rate.

DIRECT ENGINEERING LABOUR

(Professional engineers, technicians, draftsmen employed on sub-contract work).

- (1) Did you investigate nature of services rendered to ascertain that this expense is a direct cost, rather than chargeable.

(a) as a distributable cost

or (b) to other work

(a) } Investigation necessary only in cases where separately
claimed as a part of cost. If so claimed, then allowance

(b) } must be based on specific information.

- (2) Are there Department of Munitions and Supply approvals.

If not, what is authority for charge.

Allowance as a separate item should be authorized by the Director-General of the D.M. & S. Production Branch concerned.—particularly if claim is relatively large.

DIRECT FACTORY CHARGES—Miscellaneous

- (1) Experimental and Development charges—

Did you establish that these or like expenses are proper charges to costs, rather than distributable or unallowable charges.

Same conditions apply as in (1) and (2) above.

- (2) Rentals or Royalties for Machinery and Equipment—

Did you examine vouchers to verify that payment of charge related to

(a) The production period

(b) Use of machine on this work.

(a) Unless amount is very nominal, charges should be on specific basis and restricted to the actual period in which incurred.

(b) Machine or Process should be identified with War product.

NOTE: Royalties are now only allowable if approved by D.M. & S.

- (3) Demonstrations and testing expenses, travelling expenses, etc.

Did you establish these charges as reasonable and applicable.

Same conditions as (1) and (2) above.

INDIRECT COSTS

Allocation of Indirect Costs

Have these been apportioned to the sub-contract in accordance with the procedure laid down in M. & S. Form 433 (Costs of Performing a Contract or Sub-Contract).

No comment.

Indirect Factory Expenses (Factory Burden or Overhead)

On what basis are these charges applied to the costs (i.e., Direct Labour Value, Direct Labour hours, etc.)

No hard and fast rule on this point.

Relative merits of basis used should be considered in order to establish that basis used by contractor assures an equitable apportionment of charges to costs under review.

- (1) Labour—Supervision and inspection, clerical, timekeeping, store tool crib, cleaners, watchmen, etc.

Did you examine payrolls and review the rates of salary and wages for these classifications.

Proper authorization should exist for rates, etc., e.g. Payrolls should be approved by responsible Company official and should be in accordance with War Labour Board Schedules for Company.

- (2) Material and supplies—shop fuel, lubricants, waste, non-durable tools, gauges, etc.

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Did you examine vouchers and stores records or otherwise substantiate the charges.

Investigation should establish that costs under review have been fairly "loaded" with these charges. This is especially desirable where target or trial-run quantity is being audited. In such cases, tooling, etc., may be excessive in starting up period and likewise non-recurring costs should be eliminated or properly adjusted in accordance with the auditor's findings and the terms of the contract.

- (3) Service Expenses—Expenses of a general nature such as power, heat, light, repairs and maintenance of factory buildings, equipment, etc.

Were you satisfied that these charges—

- (a) applied only to the period in which the work was performed
(b) applied only to those facilities and buildings used for this work

- (c) Did not cover facilities substantially in excess of requirements.

(a) *Analysis of charges should be made to assure that individual expenses have not increased disproportionately with prior periods. Study of comparative rates should be followed by analysts of special items showing irregular or increased trend.*

(b) *Excessive amounts applicable to other facilities should be eliminated in firing rate to be accepted for costs.*

(c) *Note use of term "substantially in excess"—this relates to extraordinary situations such as non-operating plants, etc.*

- (4) Did you review the allocation of Miscellaneous Indirect Factory Expenses—Purchasing Department, salary and expenses, employee's welfare, etc.

No comment.

- (5) Were charges for repairs and maintenance of normal amount. If not, schedule items in working papers to show that these do not include expenditure of a capital nature.

Further to (3) above, this item should receive special attention due to the possibility of capital items being included therein. Where charges are very excessive, special investigation by D.M. & S. engineers may be necessary.

- (6) Did you examine the contractor's financial statements.

Necessary for comparative expense statement since subsidiary records may not give effect to year-end adjustments.

- (7) Did you include in your working papers—

- (a) Comparison of factory overhead or burden for current period with previous periods, excluding therefrom all items not properly chargeable as costs or elsewhere allowed for as direct charges.

- (a) Same condition as in (3) above.

- (b) Comparative totals of productive labour or alternative basis used.

- (c) Statement of under-absorbed overhead.

or

- (d) Statement of over-absorbed overhead.

Depreciation

- (1) Did you survey the plant records to see that all plant machinery and equipment supplied by the Government or main contractor was excluded in arriving at depreciation charges.

No problem where plant is exclusively either Company-Owned or Government-Owned. However, where part and part, a formula has to be worked out which will equitably spread charge in accordance with facts.

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- (2) Do your working papers include a schedule showing computation of depreciation of sub-contractor's own plant facilities used on this work for purpose of checking depreciation charged to production costs.

Working paper requirements should also include any additional calculation resulting from adjustment as referred to in (1) above.

- (3) Is depreciation applied in accord with provisions of rulings under:

(a) Income War Tax Act, i.e., age of asset percentage of reserve for depreciation accumulated as related to original cost

(b) Excess Profits Tax Act

(c) War Contracts Depreciation Board (i.e., "Special" Depreciation).

(a) If Reserve for Depreciation is equal to or in excess of the value of corresponding assets, against which claimed, then excess depreciation is non-allowable. In this connection it may be assumed that maintenance costs will be higher and reasonably increased amounts, if properly incurred, should be admitted to costs under such conditions.

(b) Same—as above.

(c) Special Depreciation should be supported by certificate from the War Contracts Depreciation Board. If not thus approved, then auditor's report should be qualified accordingly.

- (4) Where "Special" Depreciation is claimed, have you examined documentary evidence of approval by proper authorities.

Certificate(s) of War Contracts Depreciation Board should be obtained and calculations contained in working papers should be in accordance therewith and based on extracts therefrom.

- (5) Did you satisfy yourself that no depreciation was charged to production costs in respect of capital assets which have been fully depreciated.

Depreciation is not allowable on fully-depreciated assets?

(I) It is not an incurred cost based on Dept. of Income Tax standards.

(II) It is a factor which the Company have recovered previously.

(III) Allowance of such a cost would not "be consistent with Income Tax Dept. allowances".

Property Taxes, Rentals and Insurance

- (1) Did you ascertain that these items—

(a) applied only to the period in which the work was performed

(b) applied only to those facilities and buildings used for this work

(c) did not cover facilities substantially in excess of requirements.

(a) No comment.

(b) Amounts applicable to other facilities, etc., should be eliminated in fixing proportion to be applied to the costs under audit.

(c) Facilities substantially in excess, e.g., unoperating plants and unproductive Real Estate being sustained for peace-time purposes, should be segregated insofar as allowable operating expenses for War contracts is concerned.

- (2) Were all insurance charges included in costs permissive under the terms of the sub-contract.

D. M. & S. memorandum on subject regulates and defines such charges which are admissible. Generally speaking, it should be stated that any costs for insurance premiums on Crown property should be questioned.

AUDITS AND COST INVESTIGATIONS ON WAR CONTRACTS

Miscellaneous Indirect Expenses

- (1) Indirect Engineering Expense (Supervision salaries, Supplies, Outside Services—blue-printing, specifications, drawings, etc.)

Did you ascertain that charges under these captions were properly apportioned to this work.

Amounts admitted to costs of war work should be on pro rata basis with other similar work. Any amounts in excess (unless of nominal proportions) should be authorized either by Prime Contractor or D. M. & S. approval or request.

- (2) Workmen's Compensation Assessment

(a) Has Company received final assessment covering period during which this work was performed

(b) Will final assessment, when received, substantially affect the costs as determined.

(a) Important in case of construction projects operating with separate accounts.

(b) Should obtain final assessment prior to closing off costs for work.

ADMINISTRATION AND GENERAL EXPENSES

Has a review been made of the following—

(a) Salaries of corporate and executive officers.

(b) Were amounts paid normal compared with prior period.

Have you included in your working papers a schedule comparing salaries for the period under review with those paid for period 1936 to 1939 inclusive (please cross reference to working papers).

(c) Salaries of General Office Staff

(d) Stationery and office supplies

(e) Contributions to local charities

(f) Other necessary office expenses.

(a) Unreasonable compensation for officers and employees is a non-admissible element of cost—see item 13 page 10 following.

(b) Comparison with "standard period" provides yard stick. Nominal increase of say—up to 20%, admissible. Amounts in excess of this should be given special consideration and changes of duties defined. Particular attention in this regard should necessarily be devoted to persons in the higher income groups.

(c) } Review should establish that charges are regulated and on

(d) } a proper accounting basis.

(e) Nominal donations admissible as costs provided recipients are recognized charities. Extraordinary amounts cannot be allowed since, in fact, they would practically constitute a Government subsidy.

(f) Same as (c) and (d) above.

Did you ascertain that charges under the above or like captions are properly apportioned to the work.

On what basis are these charges applied to the costs (i.e., Cost of Sales, etc.).

Basis of apportionment should be proven equitable for the work undertaken, but no hard and fast rule prevails or is required for this purpose.

EXPENSES NOT ALLOWABLE AS COSTS

(See M. & S. Form 433)

In making your examination of the sub-contractor's books, accounts and necessary vouchers, have you satisfied yourself that none of the following have been included as (a) Direct contract costs or (b) distributable overhead expense:

THE CANADIAN CHARTERED ACCOUNTANT

1. Allowances for interest on invested capital, bonds, debentures, bank or other loans.
2. Entertainment expenses.
3. Dues and other memberships other than regular trade associations.
4. Donations (except as stated in Section 3, Sub-section b, of M. & S. 433).
5. Losses on other contracts.
6. Losses from sale or exchange of capital assets.
7. Depreciation on buildings, machinery or equipment paid for by the Crown.
8. Fines and penalties.
9. Amortization of unrealized appreciation of values of assets.
10. Expenses, maintenance and/or depreciation of excess facilities.
11. Increases in reserves for contingencies, repairs, compensation insurance and guaranteed work.
12. Federal and Provincial income, excess profits or surtaxes.
13. Unreasonable compensation for officers and employees.
14. Bond discount or finance charges.
15. Premiums for life insurance on the lives of officers.
16. Legal and accounting fees in connection with reorganizations, security issues, or capital stock issues.
17. Losses on investments, bad debts and expenses of collection.
18. Advertising and selling expenses.
19. Royalties not directly chargeable to the subject of the contract.

Signed—

.....
Senior in Charge

Approved—

.....
Auditor for Sub-Contractor

Date.....

Current Accounting Literature

A Summary Prepared by J. D. Campbell

Chartered Accountant

BULLETINS

(1) Cost Accounting

Bulletin No. 24, Volume XXIV, 15th August 1943 published by the National Association of Cost Accountants (385 Madison Avenue, New York), discusses the specialized topic of cost control technique as applied specifically to the item of factory overhead.

Cost Control—Robert W. Herr in an article "Establishing Control of Factory Overhead" presents a case study of a cost control system as applied to factory overhead. In presenting the case study three main subdivisions are set out. The first subdivision deals with the purpose and scope

of the program, the second with the actual mechanics of operation, and the third a resumé of the accomplishments which have been obtained in this particular case.

The main objectives set out in the discussion of the purpose and scope of the program are outlined namely (1) to establish responsibility for expenditures; (2) to make the operating foremen cost conscious; (3) to set up budgetary control, and (4) to take advantage of control information to obtain better cost.

In covering the purpose of making "the operating foremen cost conscious" it is pointed out that the cost information translated for him into dollars and cents would provide "the incentive to improve his operations, reduce waste and increase operating efficiency."

The actual difficulties which were encountered in the preparation of a system which would satisfy the four purposes previously mentioned are each considered. These stretch from the difficulties of establishing "control centres" to the actual mechanics involved in the preparation and presentation of the cost information. Under the new system "items which might otherwise be expenses at the time of purchase must now be carried in inventory and charged out as consumed, to insure a proper month-to-month accounting of supply costs in each department."

In conclusion a survey is presented of the actual results obtained after less than a year of operation. "This factor is contributing to more production by reducing lost time and wasted effort. As management is now able to definitely determine responsibility for all expenditures the foremen have become cost conscious."

(2) Municipal Accounting

Accounting Publication No. 10, "Standard Practice in Municipal Accounting and Financial Procedure" issued by the Municipal Finance Officers Association (Chicago, Illinois), in August 1943, presents a check list of essential principles of sound accounting procedure and of financial administration essential to the effective management of a municipality, which can be used as a yardstick in evaluating any municipality's accounting system.

The publication proper is subdivided into nine main divisions—Accounting and Treasury Duties; Budgeting; The Accounting System; Accounting Procedure; Financial

Reports; Municipal Cost Accounting; Accounting for Municipal Utilities; Independent Post-Auditing; and Conclusion.

In considering the topic of budgeting the suggestion is made that the accounting system should provide for adequate budgetary control which involves the establishment in the general ledger of budgetary accounts.

It is suggested, in outlining the fundamentals of the accounting system, that as far as practicable the accrual basis of accounting should be followed although a modified accrual basis is suggested where practical. Under the later system revenues are accounted for on a cash basis while expenditures are accounted for on an accrual basis.

In concluding it is pointed out that "no set of rules or standards is of itself sufficient to insure a good accounting system. The manner in which they are administered is an important factor".

ARTICLES

(1) Accounting Conventions

George O. May in an article "The Nature of the Financial Accounting Process" published in the July 1943 issue of *The Accounting Review* (Tappan Hall, Ann Arbor, Michigan), presents an historical outline in which it is clearly indicated that accounting conventions "are not something fixed and unalterable, but something that, like the law, should have the elements of stability and flexibility".

Mr. May suggests that conventions upon which accounting is based in order to have authority must be well conceived in relationship to "first, the uses of accounts, second, the social and economic concepts of time and place, and third the modes of thought of the people". The changing of these various factors may result in corresponding changes in accounting concepts. "Perhaps the most significant change of all is the shift of emphasis from the balance sheet to the income statement, and particularly to the income statement as a guide to earning capacity rather than as an indication of accretions to disposable income."

An historical illustration is presented supporting the contention made as to the effect which changing times have had upon financial accounting conventions. "In the early days, conservatism was the cardinal virtue of ac-

counting; now, the virtue of conservatism is questioned, and the greater emphasis is on consistency."

A projection is made of possible future changes in accounting conventions in the presentation of a series of existing alternative approaches to certain existing accounting conventions. "The interesting question is presented whether accounting is likely to move in the direction of a more complete adherence to the realization concept of income or towards wider application of the doctrine of gradual accrual."

(2) Standard Profits

J. K. Lasser in an article "Check List for Section 722(b)" which appears in the August 1943 issue of *The New York Certified Public Accountant* (15 East, 41st Street, New York), presents a summary of conditions (applicable to the U.S.) subdivided as to their application to specific circumstances under which relief might be claimed covering inadequate earnings in the base period.

The United States statute section 722 (b) performs in the United States the same duties as the Board of Referees performs in Canada covering the determination of standard profits under specific circumstances. An examination of some of the specific circumstances covered under section 722 (b) will serve to illustrate this similarity.

Section 722(b) (1) claims involve pleas that normal production output or operation was interrupted or diminished because of an occurrence immediately prior to or during the base period of events unusual or peculiar in experience to the company. Section 722(b) (2) claims involve claims where the business was depressed in the base period because of temporary economic circumstances which affected the business alone or the whole industry. Section 722(b) (3) (A) claims include cases where the business cycle did not conform to the general business cycle and earnings in the base period were therefore depressed. Section 722(b) (3) (B) claims involve instances in which profits are sporadic and intermittent and not adequately represented in the base period.

The article proper is devoted to an analysis, based on the history of cases handled, indicating what must be proven in each division in order to get recognition of abnormality and having proven abnormality how the income

will be reconstructed. The discussion of each subdivision is followed by a suggested check list of events which have been classified as abnormalities under the respective subdivisions.

(3) Wartime Accounting Problems

Hiram T. Scovill in an article "Wartime Accounting Problems" published in the July 1943 issue of *The Accounting Review* presents a short summarized outline of the major accounting problems which have been discussed in recent bulletins, releases and articles by accountants arising directly or indirectly from the present war.

The specific problems covered are cost-plus-fixed-fee contracts; reserves for post-war uncertainties; disclosure in auditor's report; "V" loans; inventories; deviation in auditing procedure inventories; treasure tax notes; payroll deductions for income tax and other items; post-war refund of excess profits tax; income tax location and disclosure. The final portion of the article covers the general problem of accounting personnel.

In covering the cost-plus-fixed-fee contracts a general conclusion is set out "that the fee could be accrued as soon as it becomes proper to bill the government for expenditures made on account of a given contract even though delivery has not been made on any part thereof" based on the fact that the "risk" element has been removed under this type of contract.

Each problem is considered separately in the form of a summary of current accounting literature which has been issued to date dealing with the respective problem.

(4) Accounting Concept-Equilibrium

F. S. Bray in an article "Internal Equilibrium" published in Vol. CIX, No. 3582 of *The Accountant* (London), discusses the question of equilibrium under the two conditions which lead to internal equilibrium within a business namely (1) ability to earn normal profits, and (2) soundness of capital structure. It is clearly set out that if accounting documents are to serve their purpose both conditions should be fairly readily discernible from the accounting documents.

In discussing the question of normal profits, it is pointed out that one of the prime problems to be met is the establishment of a uniform measurement of income.

"There can be no real abstraction of a concept of normal profits until some acceptable practice has been settled in regard to depreciation, and such like provisions."

The question of the soundness of the capital structure is considered against a background of the post-war economy. "So far as possible care should be taken to see that current operations bear their proper charges for such items as accelerated depreciation, accelerated obsolescence, and deferred maintenance, and that some kind of current provision is made to cover post-war rearrangement and alteration costs."

(5) Economic Effects—Excess Profits Tax

William J. Shultz in an article "Economic Effects of a Wartime Excess Profit Tax" published in the September 1943 issue of *Taxes—The Tax Magazine* (Commerce Clearing House Inc., 214 N. Michigan Ave., Chicago), discusses the question under the three subdivisions of effect upon prices, disturbances introduced into business and the influence on savings and investment.

In discussing the general subdivision of disturbances introduced into business three main aspects are considered namely discouragement of production, discrimination against "venture" enterprises and the expansion of business costs. "Certain costs of firms subject to wartime excess profit taxation may be increased, not merely through managerial indifference, but intentionally as a means of avoiding tax. . . . It is to the interest of firms subject to wartime excess profit tax which may be repealed after a limited period of application to expand their 'deferred profit' costs (costs re product development, goodwill bonuses to key employees, advertising, opening of branch outlets). Thereby they reduce taxable excess profits during the period of the tax's application, and reap the profit benefit of such costs after the tax has been repealed."

(6) Repair Reserve

Earl A. Saliers in an article "Theory of Repairs, Maintenance and Betterments" published in the July 1943 issue of *The Accounting Review* discusses the general accounting treatment accorded the item of repairs. The discussion covers an outline of the general recognized methods of accounting for repairs with an evaluation of each method.

"Since there is no essential difference between the phys-

ical aspects of depreciation and the physical aspects of repairs, essentially the same methods should be followed in accounting for both."

In meeting the common objection levelled at the repair reserve procedure as to the difficulty of estimating repair costs as distinguished from actual expenditures on repairs, it is pointed out that a check on past outlays will provide a fair approximation.

(7) Inventory Valuation

Arthur N. Lorig in an article "Valuing Inventories in Profit and Loss Determination" advances the suggestion covering inventory valuation that opening inventories should be valued at market and closing inventories at cost. The adoption of this procedure results in a true matching of current costs against current revenue. The adjustment from cost used for the profit and loss statement to the lower of cost or market used for the balance sheet presentation and for the opening inventory of the preceding period is set out as a charge or credit separately in the profit and loss statement. In this way profit or loss on inventories arising from market fluctuations is separated from regular operating profit or loss.

"Profits due to fluctuations in the value of inventoried items, arising in previous periods and realized in the current period, are not separated in practice. They are left buried in the operating figures for the current period which are consequently somewhat misleading. The real value of the proposed procedure lies in the avoidance of this result. The operating statement would thus become a truer index of current operating efficiency."

(8) Stock Dividend—Income

George T. Altman in an article "Effect of the Recent Stock Dividend Decisions" published in the May 1943 issue of *Taxes—The Tax Magazine* presents an analytical study of United States Supreme Courts' decisions covering the question of whether or not the stock dividend constitutes income.

Although the statutes (U.S.) in effect in 1916 provided that "a stock dividend shall be considered income to the extent of its value", the decision rendered in the case of *Eisner v. Macomber* held that a "stock dividend was not income . . . and that not being income the statute could

not make it such". Later in 1926 in the case of *Koshland v. Helvering* the courts held that if the stock dividend changed the nature of the stockholder's interest in the corporation the dividend was income. The use of the term "different" in the *Helvering* decision rather than "proportionately different" covering the question of the shareholders' interest led to two cases which were subsequently reversed on the grounds that unless the stock dividend resulted in a proportionately different interest of the various shareholders that the stock dividend did not constitute income.

Post-War Tax Proposals

IN a brief submitted to the House of Commons Special Committee on Reconstruction and Re-establishment, the Canadian Chamber of Commerce includes, among other suggestions regarding future economic policy, a number of proposals in respect to taxation in particular. This part of the brief, presented 11th June, reads as follows:

In the broadest of terms, our common objective is to maintain on the largest possible scale, in Canada, the production of the good things of life; and to see that these good things are so shared among us, as to safeguard all members of the community from want and the fear of want. We need, therefore, to secure an appropriate balance in the structure of our economy; to bring about the closest and most harmonious co-operation between government, management and labour; and to maintain in continuous employment as large as possible a proportion of the country's working force.

Our tax system should therefore be reviewed, with these three principal needs in mind.

In sum, our considered suggestions are as follows:—

Reduction of Taxation

(i) For obvious reasons the general burden of taxation should be reduced as fast as is possible, after the fighting ends. We recognize, nevertheless, that a considerable time must elapse, before we can hope to do business in a restored world market; and therefore, that it may be necessary for the victor countries, including Canada, during a period of years to continue making mutual aid appropriations on a large scale. The financing of such appropriations may set strict limits to the rate at which, consistently with prudent methods of financing, our tax rates can be lowered.

Amend Taxes on Corporations

(ii) In any case, taxation must be so designed that high levels of production and employment may be maintained; in other words, we should amend or even abolish taxes which are repressive of enterprise.

In particular, the burden of taxation on corporations cannot be maintained in time of peace at, or even close to, present levels, without serious unfavourable reactions on the common welfare.

At present, any man possessing common stock ownership, in any corporation, pays a rate of tax on the profits of that corporation, equivalent to that otherwise paid only by the rich—and the small shareholder pays this high rate of tax, no matter how small his total income may be.

We need not stress the point, at this stage in our argument, that in the general interest of all Canadians, encouragement should be given to "venture capital" from whatever source it is obtainable.

No tax which dries up the springs of enterprise should retain a place in our financial structure; we therefore believe, in principle, that the corporation tax should form no part of our tax system."

I should perhaps say there we disregard entirely the excess profits tax because that is entirely a war tax. We believe that should be taken out of the structure of our taxation, and we are talking purely of the income tax or tax on the profits of corporations, the ordinary post-war standards of ordinary taxation on the profits of companies.

"Indeed we believe investigation would demonstrate that this form of punitive double taxation produces little or no net addition to the public revenues of Canada.

We suggest that consideration be given to the British system. Under this, the corporation pays, in times of peace, what is in effect, a withholding tax, which in turn is deducted proportionately from dividend distributions to shareholders. If the tax deduction exceeds the rate to which individual shareholders are liable, a refund is granted; and if the shareholder's income falls within rates of income tax, higher than that applied to the deduction, additional tax is then collected from him.

Such a reform would avoid the present very severe double taxation on earnings derived from corporate entities.

Taxing of Averages

(iii) We believe also that the principle of levying taxes on the results of individual fiscal years is inequitable. Taxes are now payable on the full profits of successful years, giving no relief in respect of unprofitable years; and thus unduly hinder those industries which cannot make profits during periods of slack business.

At present, only losses sustained in the last preceding fiscal year may be deducted from taxable profits. We suggest that taxation should be based on an average of earnings over a period of several years; and add that this procedure would also tend to stabilize the tax receipts of government.

As an alternative, the method now used in Britain should be considered. This provides that losses may be carried forward, and set off against profits as they become available, during the six years following that in which the losses are incurred.

Losses from Obsolescence

(iv) We have already suggested that, with a view to maintaining business stability, government should permit varying rates of depreciation on capital expenditures, according to the periods when these are undertaken. In general, however, we regard as reasonable the rates at which the provision for wear and tear depreciation on certain classes of assets is at present allowed.

But when obsolescence occurs, before such assets have completed their normal working life, these rates almost inevitably prove inadequate.

The provisions of the Income War Tax Act specifically disallow deductions from taxable income, even for a realized loss resulting from obsolescence; and this despite the fact that in a number of industries,

POST-WAR TAX PROPOSALS

obsolescence is a more important factor than depreciation resulting from wear and tear.

It is true that, in certain sections of Canadian business, an innate conservatism results in the continued use of plant and machinery till it is actually worn out, even though the purchase of up-to-date equipment would result in lower production costs or a better quality product. Such conservatism is an obvious handicap and should be discarded. Provided, however, that business is prepared ruthlessly to bring itself up-to-date, we believe that a special allowance for obsolescence, making possible the necessary changes in equipment, would have great advantages.

There is an established precedent for this procedure in the practice of the British Inland Revenue. Provision is also made for this expense in the Revenue Act of the United States.

Aid Working Capital

(v) We visualize the possibility that war-time rates of taxation over a period of years may result in widespread shortages of working capital and this, just at the time when adequate working capital is most necessary to finance the "switching" of Canadian business from war tasks to peace-time production.

We therefore believe that present methods of taxation should be modified, with a view to creating more adequate reserves, and enabling Canadian business to provide against:—

- (a) losses which will be suffered on the realization of inventories in the post-war period;
- (b) repairs and replacements which would in normal times be made currently—but which are now deferred as the result of war-time shortages in material and labour; and
- (c) necessary conversion of plants from the production of munitions to production for civilian needs.

Relief to Real Estate

(vi) We believe that an unduly large proportion of all social welfare costs is paid for by means of taxes concentrated on a single source of income—real estate; and that post-war policies of social welfare will be handicapped, or even hamstrung, unless some change is made in this regard.

We therefore repeat here a recommendation, which we submitted in Ottawa five years ago, to the Royal Commission on Dominion-Provincial Relations.

At the time of Confederation, wealth was represented mainly by land, and consequently the *chief* source of taxation was real estate. But times have changed, and the forms of wealth have been diversified. Municipalities, meanwhile, have undertaken new responsibilities for social welfare services, not contemplated when their taxing powers were granted. Overwhelmingly, the financial burden of these responsibilities has fallen upon real estate; real property values have been undermined; and new construction has been effectively retarded thereby.

The wider distribution of social welfare charges would stimulate construction activities and help materially to sustain employment.

We believe also that the *form* of real estate taxation should, in the general interest, be changed. As taxes on real estate are levied at present, they run contrary to the principle, agreed upon also universally, that citizens should be taxed in accordance with ability to pay. For assessments are in most cases based on supposed capital values, without regard to the current rental income of property. We believe that such taxes should be fixed with regard to real property's

THE CANADIAN CHARTERED ACCOUNTANT

earning power; a more equitable distribution of the tax burden properly referable to real estate would obviously thus be secured.

All on Even Footing

(vii) We believe that consumers everywhere in Canada should make their contribution to the tax revenues on a comparable basis—irrespective as to whether their purchases of goods and services are made from private corporations; or from institutions in public ownership; or from mutual, or co-operative societies. Any basis of taxation other than this, obscures the true costs of doing business, and is an influence prejudicial to business efficiency.

Annuities Tax Inequitable

(viii) We regard as inequitable the present practice of collecting income tax upon the capital part of annuities. Income, in the form of an annuity, quite obviously contains two separate and distinct elements—of which one is not income in the real sense of the word at all, but a return of capital. If annuities are to remain the subject of taxation, they should therefore be taxed on a modified basis, which takes account of this fact.

One Agency for Collection

(ix) We believe that the dominion government should endeavour to maintain, after the time now provided for their expiry, the present arrangements whereby the Department of National Revenue collects all income taxes, both for its own and for the provinces' account. Moreover, the dominion government should assume the sole collection of succession duties, even if part of the sum collected is for account of, and remitted to the provinces in order to simplify procedure, minimize the cost of collection and avoid overlapping and multiple taxation.

Uniformity of Taxation

(x) In principle, moreover, we regard as anomalous and inimical to the best interests of Confederation, the possibility that individuals or corporations in different parts of the dominion should be subject to different rates of taxation, which may vary considerably from place to place. The consciousness of a common Canadian citizenship would surely be strengthened, if all tax obligations in respect of incomes, and of estates passing at death, could be fixed on a national basis.

Law Should Govern Taxing

(xi) A simpler interpretation of the taxing statutes is obviously desirable; so that taxpayers shall not any longer be bewildered by technical rulings which do not appear always to fall within the broad intentions of the statutes, and are often unimportant in the sums involved.

We regard it as axiomatic that, so far as possible, all the directions covering tax administration should be written into the law. New judicial decisions and administrative rulings should therefore, from time to time, be made the subject of special legislation and incorporated into the tax statutes—or else excluded from them, as the case may be. Thus, two statutes might well contain all income tax and succession duty legislation, with full provision for their administration also.

Probe all Revenues

(xii) We have already suggested that the time is ripe for an examination of the Canadian tariff as a whole. In the same spirit we suggest that, in addition to revising our system of taxation along the lines of these recommendations, government should inaugurate a scientific examination of the revenue system as a whole, with a view to removing other anomalies, and provisions tending to repress enterprise. For there are a number of taxes, not specifically mentioned

PERSONALS

here, which add little to the public revenue—but which tend by their influence to prevent business from being done, and so to narrow the field of employment for Canadians.

No Retroactive Taxation

(xlii) We believe that taxation should be levied in such a manner as to give the taxpayer an opportunity to plan and provide for such payment, and should not be applied on a retroactive basis.

Provincial News

BRITISH COLUMBIA

The following students were successful in passing the final and intermediate law examinations of the Institute of Chartered Accountants of British Columbia held 23rd and 24th August last:

Final: Donald F. H. Corbett (first place); J. M. Ross (second place); L. E. Cuthbertson and R. D. Young.

Intermediate: W. G. Briggs (first place); M. E. Kennedy (second place), and M. W. Angus.

PERSONALS

Messrs. W. C. Benson & Company announce the removal of their Toronto office from 57 Bloor Street West, to 86 Bloor Street West, Toronto.

Mr. S. C. Ferguson, chartered accountant, formerly with John Labatt Limited, announces that he has opened an office for the practice of his profession at 1 Market Square, London, Ontario.

Messrs. Deloitte, Plender, Haskins & Sells regret to announce that owing to ill-health Mr. W. J. Saunders, F.C.A., F.S.A.A. (Eng.), retired from the Canadian partnership on June 30, 1943. Mr. Saunders will continue to be associated with the firm in an advisory and consultative capacity.

INCOME TAX, FEMALE COMMISSIONED OFFICERS

By a decision of the Treasury Board, approved by Order in Council on 7th July, 1943, female commissioned officers are brought under the special provisions of the income tax act. The ruling provides as follows: "The figure to be used in the application of rule 2 of section 3 of paragraph A of the first schedule to *The Income War Tax Act* in respect of the 1942 taxation period with respect to female commissioned officers of the Women's Royal Canadian Naval Services, Canadian Women's Army Corps and the Royal Canadian Naval Services, Canadian Women's Army Corps and the Royal Canadian Air Force (Women's Division) shall be \$1,022 in lieu of the figure of \$1,600 mentioned in the said rule 2, but the rate in respect of other female commissioned officers shall be \$1,600."

OBITUARIES

The Late William T. Kernahan

The Institute of Chartered Accountants of Ontario regrets to announce the sudden death of William Thomas Kernahan at Toronto on August 22nd, 1943.

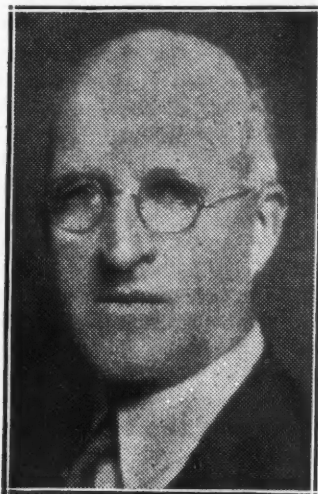
The late Mr. Kernahan in a few months would have completed fifty years of membership in the Institute, having passed the prescribed examinations and been elected to membership November 21st, 1893. While not engaged in public practice, Mr. Kernahan always took an active interest in the affairs of the Institute. He served on Council and was elected president in 1904-5. In 1903 he was elected a Fellow of the Institute and a life member in 1908. This interest has continued through the years and Mr. Kernahan was seen annually at the mid-winter dinner and invariably brought along his friends. As recently as April last he attended a meeting of the Advisory Board of Past Presidents.

To his family the Institute offers sincere sympathy for it has lost a very valuable member.

The Late Robert Wilson

The President and Council of The Society of Chartered Accountants of the Province of Quebec announce with deep regret the passing of Robert Wilson on September 7th, 1943, after a long illness. The late Mr. Wilson was senior partner of Wilson, Birnie & Seymour, chartered accountants.

Admitted to membership in the year 1908, Mr. Wilson was a member of the Quebec Society for over thirty-five years, twenty-six years of which he served as secretary-treasurer of the Society. During this time his services in the interests and development of the Society were able and outstanding. The present prosperous and prominent posi-



ROBERT WILSON, C.A.

tion which the Society now enjoys was made possible in no small measure through his efforts. His death is a personal loss to the members of the Quebec Society.

Mr. Wilson was not only a prominent member of the profession of accountancy, known and respected for his integrity and ability throughout the whole of the Dominion, but gave generously of his time and talents to Church and Hospital work and public spirited enterprises.

To his wife and daughter the members extend their sincere sympathy.

STUDENTS' DEPARTMENT

R. G. H. SMAILES, C.A., Editor

NOTES AND COMMENT

In his presidential address to The Dominion Association of Chartered Accountants Mr. Kris A. Mapp expressed the belief that management of industry would welcome the disappearance of many of the historical conventions in accountancy and the adoption of a set of financial statements that would be more intelligible to the public at large. Undoubtedly these conventions, more than anything else, are responsible for the suspicion and distrust with which the public regards the accountant and his works and equally certainly no one would be more glad to see them go than the accountant himself. But is it possible to dispense with them without becoming involved in new and possibly greater difficulties?

What might be called the basic convention in the preparation of accounting statements is the presentation of fixed assets at figures representing historic cost less estimated depreciation to date. It is perfectly true that profit or loss computed by reference to such a treatment of fixed assets does not measure income as the economist would like to have it measured. The economist's measure of income is one derived from the statement of all assets, including fixed assets, at the present worth of their realizable value. But the realizable value of a fixed asset is dependent upon the income which it will yield over its life—and so we find ourselves in a position where value depends on income and income depends on value with the result that neither income nor value is determinate. What is the accountant to do in face of this dilemma if he abandons his conventional depreciated cost statement of fixed assets? For ourselves we see no way out of this particular difficulty and can only suggest that the accountant while clinging to his convention should see to it that in any published income statement the profit or loss *before* depreciation be shown and that the subsequent deduction for depreciation be clearly portrayed for what it is, viz., a round sum provision for that portion of the capitalized

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earning capacity which has been exhausted, and a provision whose amount is at the discretion of management and is not objectively measureable.

* * *

The British reaction to the recently published summary of the revised currency scheme of the United States Treasury appears to be anything but favourable, the feeling being that the attempt to prevent variations in exchange values by internal deflation is bound to produce mass unemployment. "To accept anything like this plan" says one writer "would be like returning to 1925, and if there is anything on which British opinion is entirely united it is on rejecting such a proposition with horror . . . Let it be said at once that no British government could accept anything remotely like these proposals and remain in power beyond the first post-war election."

* * *

STUDENTS' ASSOCIATION NOTES

QUEBEC

The members of the Chartered Accountants Students' Society of the Province of Quebec have learned with deep regret that the name of Flying Officer Elson Cunningham is included in the latest R.C.A.F. casualty list from Ottawa and that he is now for official purposes presumed dead.

Another Quebec student is also reported missing. Word has been received by the parents of Flt.-Sgt. William Grindley that he has been reported missing on operations with the R.C.A.F. overseas.

The members of the Students' Society extend their sincere sympathy to the parents of these two fine boys and hope that they will eventually be found safe and well.

PROBLEMS AND SOLUTIONS

THE PROVINCIAL INSTITUTES OF CHARTERED ACCOUNTANTS

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

THE CANADIAN CHARTERED ACCOUNTANT

PROBLEM I

INTERMEDIATE EXAMINATIONS, DECEMBER 1942

Accounting I, Question 5 (35 marks)

From the following trial balance, after giving effect to the necessary adjustments indicated, prepare

- (a) profit and loss account, and
- (b) balance sheet

having due regard to proper classification and form.

	Dr.	Cr.
Cash	\$ 25,324	
Land	100,000	
Buildings	200,000	
Tools and fixtures	40,430	
Motor trucks	30,000	
Office furniture	5,201	
Bills receivable	25,812	
Accounts receivable	163,374	
Marketable securities (cost and market value) ..	20,000	
Advances on salesmen's salaries	1,960	
Organization expenses	4,700	
Goodwill	200,000	
Bills payable		\$ 42,000
Accounts payable		98,011
Payroll		15,363
Reserve for bad debts		112
Reserve for depreciation of buildings		10,000
Reserve for depreciation of office equipment ...		500
Reserve for depreciation of tools and fixtures ..		4,000
Reserve for depreciation of motor trucks		7,500
Share capital (8,000 shares)		800,000
Surplus		35,870
Sales, less returns and allowances		940,000
Inventory (at beginning of year)	114,621	
Purchases, including freight and duty	695,612	
Wages of warehouse staff	70,400	
Wages of drivers	30,000	
Salaries of officers and clerical staff	75,120	
Salaries of salesmen	60,440	
Salesmen's travelling expenses	15,000	
Advertising	33,300	
Property taxes	4,020	
Insurance—Buildings	500	
Motor trucks	1,800	
Merchandise	3,600	
Interest and discount	6,500	
Miscellaneous general expenses	9,750	
Maintenance and repairs of building	5,942	
Truck expenses and supplies	10,450	
Interest earned on securities		500
	<u>\$1,953,856</u>	<u>\$1,953,856</u>

The foregoing figures relate to the transactions of one year at the close of which the inventory of merchandise was \$270,560 and

STUDENTS' DEPARTMENT

prepaid insurance premiums amounted to \$2,000 (relating to policies covering buildings, \$100; motor trucks, \$300; and merchandise, \$1,600). Unpaid warehouse wages amounted to \$5,750.

Add to the reserve for bad debts \$1,000, and provide for depreciation at the following rates applied to the relative asset values shown above—buildings 5%, office equipment 10%, tools and fixtures 10%, motor trucks 20%.

Of the net income for the year set aside 30% for income taxes.

The authorized capital is \$1,000,000 consisting of 10,000 shares of a par value of \$100 each.

There were no contingent liabilities at the end of the year under review.

SOLUTION

..... Limited			
Profit and Loss Account			
For the Year Ended			
Sales—net			\$940,000.00
Cost of sales:			
Purchases	\$695,612.00		
Increase in inventory:			
Closing inventory	\$270,560.00		
Opening inventory	114,621.00	155,939.00	539,673.00
Gross profit			400,327.00
Selling expenses:			
Wages of warehouse employees	76,150.00		
Delivery expenses—trucks:			
Wages	30,000.00		
Expenses	10,450.00		
Insurance	1,500.00		
Depreciation	6,000.00		
Salesmens' salaries	60,440.00		
Salesmens' expenses	15,000.00		
Advertising	33,300.00	232,840.00	
Administration and general expenses:			
Salaries of officers and clerical staff	75,120.00		
Miscellaneous general expenses	9,750.00		
Maintenance of buildings and equipment	5,942.00		
Property taxes	4,020.00		
Insurance—Buildings	400.00		
—Merchandise	2,000.00		
Depreciation—Buildings	10,000.00		
—Office equipment	520.10		
—Tools and fixtures	4,043.00	111,795.10	
Miscellaneous charges:			
Interest and discount	6,500.00		
Less: Interest earned	500.00		

THE CANADIAN CHARTERED ACCOUNTANT

	6,000.00		
Bad debts	1,000.00	7,000.00	351,635.10
Net income, before providing for income taxes ..			48,691.90
Provision for income taxes			14,607.57
Net Income			<u>\$ 34,084.33</u>

..... Limited
Balance Sheet
As at

ASSETS

Current assets:			
Cash			\$ 25,324.00
Bills and accounts receivable:			
Bills receivable	\$ 25,812.00		
Accounts receivable	163,374.00		
	189,186.00		
Less: Reserve for bad debts	1,112.00		
	188,074.00		
Advances to employees	1,960.00		190,034.00
Merchandise			270,560.00
Marketable securities (market value) ..			20,000.00
Total current assets			505,918.00
Prepaid insurance			2,000.00
Plant and equipment:			
Land	100,000.00		
Buildings	\$200,000.00		
Tools and fixtures	40,430.00		
Motor trucks	30,000.00		
Office furniture	5,201.00		
Total cost	275,631.00		
Less: Reserve for depreciation	42,563.10	233,067.90	333,067.90
Organization expenses			4,700.00
Goodwill			200,000.00
			<u>\$1,045,685.90</u>

LIABILITIES

Current Liabilities:			
Notes payable		\$ 42,000.00	
Accounts payable		98,011.00	
Payroll		21,113.00	
Provision for income taxes		14,607.57	
Total current liabilities			175,731.57
Share capital:			
Authorized—10,000 shares, par value \$100.00 each			

STUDENTS' DEPARTMENT

Issued	— 8,000 shares	.....	\$800,000.00		
Surplus:					
Balance at beginning of the					
year	.....	\$35,870.00			
Net income for the year to date	34,084.33		69,954.33	869,954.33	
Contingent liabilities—none					
					<u>\$1,045,685.90</u>

PROBLEM II

FINAL EXAMINATIONS, DECEMBER 1942

Accounting III, Question 3 (15 marks)

A died on 1st March 1942. The executors of his estate are permitted under the terms of the will to retain all the investments included in his assets. The income from the estate is to go to his widow during her lifetime and on her death the assets are to be distributed to his daughter. Certain of the transactions of the estate are set out below and you are asked to make an allocation of these transactions as between corpus and income:

Testamentary expenses	.....	\$ 700
Funeral expenses	.....	500
Profit on sale of investment	.....	5,000
Dividend on common stock declared 25th February 1942 to shareholders of record 28th February 1942 and received 10th March 1942	.....	1,000
Dividend on preferred stock:		
For quarter ending 1st April 1942	.....	600
For quarter ending 1st July 1942	.....	600
Final dividend of 2% on a common stock received in respect of year ended 1st September 1942	.....	1,200
The interim dividend of 4% was received by A prior to his death.		
Paid to widow on account of income	.....	500
Paid mortgage interest on residence for six months ending 1st June 1942	.....	1,000
Proceeds of mortgage on which interest was paid to 1st March 1942 but at date of realization principal was \$4,950 and interest unpaid \$50	.....	4,000
Accruals may be calculated on a monthly basis for the purpose of this problem.		

(Note: State what basis you have used for the apportionment of income.)

SOLUTION

ALLOCATION OF TRANSACTIONS AS BETWEEN CORPUS AND INCOME

	Corpus	Income	Total
Testamentary expenses	\$ 700		\$ 700
Funeral expenses	500		500
Profit on sale of investment	5,000		5,000
Dividend on common stock declared 25th February 1942 to shareholders of record 28th February 1942 and received 10th March 1942	1,000		1,000
Dividend on preferred stock—			

For quarter ending 1st April 1942			
Corpus 2 months	490		
Income 1 month		200	600
For quarter ending 1st July 1942		600	600
Dividend on common stock for year ended 1st			
September 1942		1,200	1,200
Final2%			
Interim4%			
Total6%			
Applicable to corpus			
6 months or 3%			
However no cash received by deceased can be considered as income so all of this receipt is income but no more.			
Paid to widow on account of income		500	500
Paid mortgage interest for 6 months ending 1st June 1942			
Corpus 3 months—½	500		
Income 3 months—½		500	1,000
Proceeds of mortgage—no interest in arrears 1st March 1942:			
At date of realization—			
Principal\$4,950	99%		
Interest 50	1%		
	<u>\$5,000</u>	100%	
99% to corpus	3,960		
1% to income		40	4,000
	<u>\$12,060</u>	<u>\$3,040</u>	<u>\$15,100</u>

(Kindly supplied by The Canadian Bank of Commerce, Toronto)

	31st Aug. 1943	15th Sept. 1943
U.S. Dollars	10-11% P.	10-11% P.
Sterling	443-447	443-447
Australian Pounds	358½	358½
New Zealand Pounds	360	360
South African Pounds	443	443
British West Indies—Dollars	9270	9270
India—Rupees	3356	3356
Hong Kong—Dollars (Custodian rate)	2781	2781
Straits Settlements—Dollars (Custodian rate)	5226	5226
Sweden—Kronor	2633	2633
Switzerland—Francs	2569	2569

Note: The above currencies are expressed as follows: Pound currencies—Canadian cents per unit; Continental currencies and sundry British Empire—Canadian cents per 100 units.

